

**Memorandum**

Date **MAY 24 2002**

From Janet Rehnquist
Inspector General *Janet Rehnquist*

Subject Audit of the Pension Plan at a Terminated Medicare Contractor, Transamerica Occidental Life Insurance Company (A-07-01-00125)

To Thomas A. Scully
Administrator
Centers for Medicare & Medicaid Services

As part of an ongoing collaborative effort between the Office of Inspector General and the Centers for Medicare & Medicaid Services, we are alerting you to the issuance within 5 business days from the date of this memorandum of our final audit report entitled, "Audit of the Pension Plan at a Terminated Contractor, Transamerica Occidental Life Insurance Company." A copy of the report, identifying approximately \$20.2 million in excess pension assets is attached.

The Transamerica Occidental Life Insurance Company (TOLIC) was a Medicare contractor until its contract was terminated in 2000 and, as such, was allowed to claim Medicare reimbursement for their Medicare employees' pension costs. Regulations and the Medicare contract provide, however, that pension gains, which occur when a Medicare segment of a pension plan closes, should be credited to the Medicare program. Accordingly, we are recommending that TOLIC remit about \$20.2 million in excess pension assets to the Medicare program.

The TOLIC disagreed with certain aspects of our calculations, and asserted that they found no basis to depart from their own computations. The TOLIC computed excess pension assets of about \$9.4 million. We disagree with TOLIC's assertions and found nothing in TOLIC's response to cause us to change our opinion.

If you need additional information about this report, please contact George M. Reeb, Assistant Inspector General for Health Care Financing Audits, at (410) 786-7104 or James P. Aasmundstad, Regional Inspector General for Audit Services, Region VII, at (816) 426-3591.

Attachment

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**AUDIT OF THE PENSION PLAN AT A
TERMINATED CONTRACTOR,
TRANSAMERLCA OCCIDENTAL LIFE
INSURANCE COMPANY**



**JANET REHNQUIST
Inspector General**

**MAY 2002
A-07-01-00125**



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General
Office of Audit Services

Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

CIN: A-07-01-00125

MAY 29 2002

Mr. James W. Dederer
Executive Vice President and General Counsel
Transamerica Occidental Life Insurance Company
1150 South Olive
Los Angeles, California 90015

Dear Mr. Dederer:

This report provides the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review entitled, "*Audit of the Pension Plan at a Terminated Medicare Contractor, Transamerica Occidental Life Insurance Company.*" The purpose of our review was to evaluate Transamerica Occidental Life Insurance Companies (TOLIC) compliance with the pension segmentation requirements of its Medicare contract and to determine the excess assets that should be remitted to Medicare as a result of the termination of the Medicare contractual relationship effective November 30, 2000.

We computed excess pension assets of \$20,227,001 which TOLIC should remit to the Federal Government. The TOLIC disagreed with certain aspects of our calculations, and asserted that excess pension assets of \$9,362,556 should be remitted to the Federal Government. The TOLIC's redacted response is included as Appendix B. Appendix C contains the Centers for Medicare & Medicaid Services (CMS), Office of the Actuary's comments on TOLIC's response.

INTRODUCTION

BACKGROUND

The TOLIC administered Medicare Part B under cost reimbursement contracts until the contractual relationship terminated in 2000. In claiming costs, contractors were to follow cost reimbursement principles contained in the Federal Procurement Regulations (FPR), which were superseded by the Federal Acquisition Regulations (FAR), the Cost Accounting Standards (CAS), and the Medicare contracts.

Since its inception, Medicare has paid a portion of the annual contributions made by contractors to their pension plans. These payments represented allowable pension costs under the FPR and/or the FAR. In 1980, both the FPR and Medicare contracts incorporated CAS 412 and 413.

The CAS 412 regulates the determination and measurement of the components of pension costs. It also regulates the assignment of pension costs to appropriate accounting periods.

The CAS 413 regulates the valuation of pension assets, allocation of pension costs to segments of an organization, adjustment of pension costs for actuarial gains and losses, and assignment of gains and losses to cost accounting periods.

The CMS, formerly the Health Care Financing Administration, incorporated segmentation requirements into Medicare contracts starting with Fiscal Year 1988. The contractual language specifies segmentation requirements and also provides for the separate identification of the pension assets for a Medicare segment.

The Medicare contract defines a segment, and specifies the methodology for the identification and initial allocation of pension assets to the Medicare segment. Furthermore, the contract requires that the Medicare segment assets be updated for each year after the initial allocation in accordance with CAS 413.

In our report entitled, "*Audit of Medicare Contractor's Segmented Pension Costs, Transamerica Occidental Life Insurance Company*," dated August 19, 1991 (A-07-91-00391), we addressed the computation of the asset fraction, the identification of the segment's assets as of January 1, 1986, and updated segment assets to January 1, 1988. We determined Medicare segment assets to be \$5,636,116 as of January 1, 1988.

The TOLIC was purchased by AEGON USA, Inc. in July 1999. Subsequently, TOLIC's Medicare Part B contract was terminated on December 1, 2000. The majority of TOLIC's Medicare segment employees were terminated and the Medicare segment was closed on that date. Contract terminations and segment closings are addressed by CAS at 9904.413-50(c)(12), which states:

"If a segment is closed,...the contractor shall determine the difference between the actuarial accrued liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated. The difference between the market value of the assets and the actuarial accrued liability for the segment represents an adjustment of previously determined pension costs.

(i) The determination of the actuarial accrued liability shall be made using the accrued benefit cost method. The actuarial assumptions employed shall be consistent with the current and prior long-term assumptions used in the measurement of pension costs...

(iii) The calculation of the difference between the market value of the assets and the actuarial accrued liability shall be made as of the date of the event (e.g. contract termination, plan amendment, plant closure) that caused the closing of the segment...If such a date is not readily determinable, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date."

Medicare contracts specifically prohibit any profit (gain) from Medicare activities. Therefore, according to the contract, pension gains that occur when a Medicare segment terminates should be credited to the Medicare program. In addition, FAR addresses dispositions of gains in

situations such as contract terminations. When excess or surplus assets revert to a contractor as a result of termination of a defined benefit pension plan, or such assets are constructively received by it for any reason, the contractor shall make a refund or give credit to the Government for its equitable share (FAR, section 31.205-6(j)(4)).

OBJECTIVES, SCOPE, AND METHODOLOGY

We made our examination in accordance with generally accepted government auditing standards. Our objectives were to determine TOLIC's compliance with pension segmentation requirements of its Medicare contract, and to determine the amount of excess assets that should be remitted to Medicare as a result of the contract termination and Medicare segment closing. Achieving our objectives did not require a review of TOLIC's internal control structure.

The TOLIC's Medicare contract was terminated and the Medicare segment closed on December 1, 2000. The TOLIC suggested, and we agreed, that January 1, 2001 would be an appropriate settlement date for the closing of the segment. We, therefore, reviewed TOLIC's identification of the Medicare segment and its update of Medicare assets from January 1, 1988 to January 1, 2001.

In performing the review, we used information provided by Transamerica Pension Services, TOLIC's actuary. The information included liabilities, normal costs, contributions, benefit payments, earnings, and administrative expenses. We reviewed TOLIC's accounting records, pension plan documents, annual actuarial valuation reports, and the Department of Labor/Internal Revenue Service Form 5500s. Using these documents, we calculated Medicare segment assets as of January 1, 2001. The CMS pension actuarial staff reviewed our methodology and calculations.

Site work at TOLIC's corporate offices in Los Angeles, California was performed during January and February 2001. We performed subsequent audit work in our OIG, OAS Jefferson City, Missouri field office.

FINDINGS AND RECOMMENDATIONS

When TOLIC's Medicare segment closed, Medicare's share of the excess pension assets was \$20,227,001, which we are recommending be remitted to CMS. To determine Medicare's share, it was necessary to (1) update segment assets to January 1, 2001, and (2) calculate the actuarial liability for accrued benefits for the segment and the excess Medicare assets.

MEDICARE ASSET BASE AS OF JANUARY 1, 1988 UPDATED TO JANUARY 1, 2001

As of January 1, 1988, TOLIC correctly identified Medicare segment assets totaling \$5,636,116. However, TOLIC's methodology in updating the Medicare segment assets from January 1, 1988 to January 1, 2001 resulted in an understatement of Medicare segment assets of \$5,682,960. This understatement occurred because TOLIC: (1) overstated benefit payments, (2) overstated

pension contributions, (3) understated earnings and expenses, and (4) made incorrect adjustments to the December 31, 2000 Medicare segment assets.

Benefit Payments

Due to the incorrect identification of retirement benefit payments made to Medicare segment participants, TOLIC understated segment assets. We identified the actual retirement benefits paid to segment participants and assigned these payments to the segment. This resulted in a net increase of \$153,859 in the segment assets. A comparison of TOLIC's and our benefit payment amounts are shown on the following schedule.

Benefit Payments to Medicare Retirees

<u>Year</u>	<u>TOLIC</u>	<u>OIG</u>	<u>Variance</u>
1988	\$57,275	\$41,941	\$15,334
1989	60,291	44,856	15,435
1990	70,975	52,473	18,502
1991	88,200	72,968	15,232
1992	123,881	111,919	11,962
1993	185,021	169,790	15,231
1994	211,665	208,960	2,705
1995	341,936	339,232	2,704
1996	357,083	348,986	8,097
1997	365,352	351,861	13,491
1998	470,353	459,567	10,786
1999	481,600	469,543	12,057
2000	<u>505,638</u>	<u>493,315</u>	<u>12,323</u>
Total	<u><u>\$3,319,270</u></u>	<u><u>\$3,165,411</u></u>	<u><u>\$153,859</u></u>

Pension Contributions

The TOLIC's update methodology did not equitably assign pension contributions to the Medicare segment. As a result, TOLIC overstated segment assets by \$131,438. The TOLIC used salaries to allocate a portion of the total company pension contributions to the segment. Using this methodology, TOLIC computed segment contributions of \$6,075,938 for the years 1988 through 2000. However, TOLIC's segment contributions did not reconcile to the segment pension costs claimed for Medicare reimbursement.

We assigned contributions to the segment based on the pension cost that TOLIC claimed for Medicare reimbursement. Using this methodology, we computed total Medicare segment contributions of \$5,944,500 for the years 1988 through 2000. Our calculations decreased the segment assets by \$131,438. A comparison of TOLIC's and our calculation of pension contributions follows:

Contribution Variance for the Medicare Segment

<u>Year</u>	<u>Contributions Per TOLIC</u>	<u>Contributions Per OIG</u>	<u>Variance</u>
1988	\$738,544	\$748,407	(\$9,863)
1989	740,930	714,624	26,306
1990	957,630	980,453	(22,823)
1991	985,641	909,307	76,334
1992	579,606	520,255	59,351
1993	1,101,780	1,151,747	(49,967)
1994	971,807	919,707	52,100
1995	0	0	0
1996	0	0	0
1997	0	0	0
1998	0	0	0
1999	0	0	0
2000	0	0	0
Total	<u><u>\$6,075,938</u></u>	<u><u>\$5,944,500</u></u>	<u><u>\$131,438</u></u>

Earnings and Expenses

The TOLIC's update methodology incorrectly allocated investment earnings and expenses. The TOLIC allocated earnings and expenses based on a ratio of the beginning of the year (BOY) Medicare segment assets to total company assets. Based on this methodology, TOLIC computed net earnings of \$40,616,639 for the years 1988 through 2000.

In our prior review of TOLIC's Medicare segment assets, we determined that TOLIC allocated earnings and expenses based on an "average value of assets" methodology. We accepted TOLIC's methodology and used it in our update of segment assets from January 1, 1986 to

January 1, 1988. This same methodology was later implemented into the revised CAS at 413-50(c)(iii)(7) which states:

“Income and expenses of the pension plan assets shall be allocated to the segment in the same proportion that the average value of assets allocated to the segment bears to the average value of total pension plan assets for the period for which income and expenses are being allocated.”

Beginning January 1, 1988, TOLIC changed its accounting methodology and began allocating earnings and expenses based on BOY assets. This accounting method change was made without prior approval, and we found no justification for the change. Therefore, we consistently applied the “average value of assets” allocation methodology for all years.

The revised CAS became applicable to TOLIC the first plan year after the March 30, 1995 revision date. Therefore, TOLIC was required to allocate earnings and expenses based on the “average value of assets” for plan years 1996 through 2000.

Using the “average value of assets” methodology, we computed net earnings of \$41,852,952 for the years 1988 through 2000. Our computation of net earnings increased Medicare segment assets by \$1,236,313. A comparison of TOLIC's and our audited net earnings and expenses are shown on the following schedule.

<u>Year</u>	<u>TOLIC Net Earnings</u>	<u>OIG Net Earnings</u>	<u>Net Earnings Variance</u>
1988	\$441,963	\$466,021	(\$24,058)
1989	1,026,491	1,072,546	(46,055)
1990	(180,949)	(162,306)	(18,643)
1991	2,086,910	2,273,698	(186,788)
1992	1,086,913	1,118,881	(31,968)
1993	2,798,330	2,924,127	(125,797)
1994	(199,985)	(101,052)	(98,933)
1995	5,091,896	5,207,596	(115,700)
1996	3,601,206	3,668,108	(66,902)
1997	6,894,797	7,033,051	(138,254)
1998	11,573,574	11,807,004	(233,430)
1999	11,863,155	12,127,774	(264,619)
2000	<u>(5,467,662)</u>	<u>(5,582,496)</u>	<u>114,834</u>
Total	<u>\$40,616,639</u>	<u>\$41,852,952</u>	<u>(\$1,236,313)</u>

Adjustments to December 31, 2000 Medicare Segment Assets

The TOLIC made two adjustments to the December 31, 2000 Medicare segment assets. First, TOLIC reduced the segment assets by \$4,406,089 for lump-sum payments made under the Transamerica Retention and Retirement Program (*TARRP*). Second, TOLIC reduced the segment assets by \$224,376 for monthly annuity and lump-sum payments paid after the yearend.

Transamerica Retention and Retirement Program

The TOLIC reduced the segment assets by \$4,406,089 for lump-sum payments made under the TARRP. We determined these payments were unallowable for Medicare reimbursement under the FAR.

The TOLIC maintained a Separation Pay Plan, which provided severance benefits to employees in the event of involuntary termination of employment. Additionally, in March 2000, TOLIC requested and received CMS's approval for the TOLIC Medicare Transition Retention Bonus Plan. Subsequently, TOLIC also adopted the TARRP. The TOLIC requested, but did not receive, CMS's approval for the TARRP. Summary information on the TARRP that TOLIC distributed to its employees states:

“...TARRP has been established by the Company to provide special benefits to eligible Transamerica employees to encourage them to remain with the Company and be productive in their positions while the integration strategy with AEGON is being implemented. The TARRP will provide enhanced separation benefits for those eligible employees whose employment is terminated for Qualifying Reasons, as defined in this Summary, by a Participating Company within a three-year period after the merger with AEGON (the “TARRP Window Period” from July 21, 1999 through July 20, 2002).”

Compensation incidental to business acquisitions is addressed by FAR 31.205-6(l), which states:

“The following costs are unallowable:

(1) Payments to employees under agreements in which they receive special compensation, in excess of the contractor's normal severance pay practice, if their employment terminates following a change in the management control over, ownership of the contractor or a substantial portion of its assets.

(2) Payments to employees under plans introduced in connection with a change (whether actual or prospective) in the management control over, or ownership of, the contractor or a substantial portion of its assets in which those employees receive special compensation, which is contingent upon the employee remaining with the contractor for a specified period of time.”

The TARRP provided special compensation to TOLIC employees in excess of TOLIC's normal severance plan. Additionally, the TARRP was introduced in connection with a change in

company ownership. Therefore, in accordance with the FAR, we determined that the TARRP lump-sum payments of \$4,406,089 were unallowable.

Monthly Annuity and Lump-Sum Payments

The TOLIC also reduced the segment assets by \$224,376 for monthly annuity and lump-sum payments paid after the yearend. We determined that the actual retirement benefits paid to segment participants after the yearend were \$206,239.

Medicare Assets as of January 1, 2001

We updated pension assets of the Medicare segment from January 1, 1988 to January 1, 2001 (see Appendix A). Our calculation showed that the Medicare segment assets increased by \$5,682,960 to \$50,061,918 as of January 1, 2001. This increase resulted from (1) adjusting for benefit payments (\$153,859 increase), (2) assigning pension contributions equitably to the Medicare segment (\$131,438 decrease), (3) revising net segment earnings and expenses (\$1,236,313 increase), and (4) revising adjustments to the December 31, 2000 segment assets (\$4,424,226 increase).

The primary difference between TOLIC's identification of the January 1, 2001 Medicare segment assets and ours was due to TOLIC's inclusion of \$4,406,089 in unallowable TARRP payments. Additionally, TOLIC understated the segment's net earnings by \$1,236,313.

CALCULATION OF ACTUARIAL ACCRUED LIABILITY AND EXCESS MEDICARE ASSETS

When TOLIC terminated its Medicare contract, it elected to purchase annuity liability insurance for its Medicare employees rather than continue to carry their pension liability in the pension plan. The TOLIC solicited bids for the annuity purchase from four companies, one of which was TOLIC itself. Principal Life Insurance Company submitted the lowest bid of \$28,678,987, while TOLIC submitted the highest bid of \$31,342,000. After obtaining assurance that purchasing an annuity from itself would not be considered a prohibited transaction under the Employee Retirement Income Security Act, TOLIC accepted its own bid. Subsequently, TOLIC finalized the number of Medicare eligible participants and purchased the annuity insurance contract from itself for \$32,864,127.

TOLIC's Annuity Purchase

We reviewed TOLIC's annuity insurance purchase as it pertained to its Medicare contract and the FAR. We determined that TOLIC failed to exercise its fiduciary responsibilities to protect government assets by not accepting the lowest legitimate bid for the purchase of the annuity. The TOLIC's Medicare contract, at Article XV, subsection B, states:

“In determining the costs allowable under this contract, the Secretary shall take into account the amount which is reasonable and adequate to meet the cost which must be incurred by an efficiently and economically operated Carrier in carrying out the terms of

this contract. The types of cost allowable and allocable under this contract shall be determined in accordance with the provisions of Part 31 of the FAR, as interpreted and modified by Appendix B of this contract.”

The FAR at 31.205-19(b) states:

“If purchased insurance is available, the charge for any self-insurance coverage plus insurance administration expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administration expenses.”

Based on TOLIC's Medicare contract and the FAR, we determined that TOLIC should have accepted the lowest legitimate bid. The TOLIC had a fiduciary responsibility as a Medicare contractor to safeguard government assets. Therefore, TOLIC should have accepted Principal's bid of \$28,678,987.

In consideration of changes made between TOLIC's preliminary bid and the final purchase amount, we inflated Principal's bid by the ratio of the final purchase amount to TOLIC's preliminary bid. This computation inflated Principal's bid to \$30,093,789. However, we determined that TOLIC incorrectly included four participants with liabilities totaling \$258,873 in the annuity purchase. Consequently, we determined the Medicare segment final liability was \$29,834,916.

Excess Medicare Pension Assets

To determine the excess Medicare pension assets, we reduced the January 1, 2001 Medicare segment assets of \$50,061,918 by the allowable Medicare segment final liability of \$29,834,916. The difference of \$20,227,002 represents excess Medicare pension assets that must be remitted to the Federal Government.

Recommendation

We recommend that TOLIC refund \$20,227,001 of excess Medicare pension assets resulting from the termination of its Medicare contract to CMS.

Auditee's Comments

The TOLIC's comments are summarized in the following paragraphs and its redacted response (less attachments) is presented in detail in Appendix B. The CMS Office of the Actuary's response is presented in Appendix C.

The TOLIC disagreed with our report and stated:

“TOLIC maintains that its adjusted pension assets are \$44,306,723, that those assets should be reduced by \$33,259,459 (which represents the entire final purchase price of the annuity liability contract) and that the difference should be reduced by the 15.25% decrease in pension asset value from January 1, 2001 to September 30, 2001. This results in \$9,362,556 in excess pension assets TOLIC must remit to the government.”

The TOLIC contends that we: (1) incorrectly computed the update of Medicare segment pension assets from January 1, 1988 to January 1, 2001, (2) were incorrect in our disallowance of certain adjustments to the January 1, 2001 segment assets, (3) incorrectly adjusted the annuity insurance purchase to the lowest bid, and (4) should reconsider the January 1, 2001 segment closing date due to market changes and use September 30, 2001 as the new segment closing date.

The TOLIC asserted that our update of segment assets for the period of January 1, 1988 to January 1, 2001 was incorrect for several reasons. First, TOLIC disagreed with our findings concerning benefit payments that increased segment assets by \$153,859. The TOLIC stated that it provided documentation for an additional \$51,344 of benefit payments. Therefore, it believed that benefit payments were only overstated by \$102,515 (\$153,859 - \$51,344).

The TOLIC also disagreed with our calculation of earnings and expenses for the review period. The TOLIC believed that it was following the CAS for the years 1988 through 2000. The TOLIC also believed that the revised CAS was not applicable to TOLIC because its contract was not subject to the CAS. For 1988 through 1995, TOLIC stated:

“TOLIC utilized the average value of assets methodology through 1987; in fact, the OIG relied on this method in its earlier segment audit, entitled “Audit of Medicare Contractor’s Segmented Pension Cost, Transamerica Occidental Life Insurance Company,” dated August 19, 1991. However, the CAS 413 provision incorporated into TOLIC’s November 1987 contract for fiscal year 1988 required the use of the BOY methodology. Thus, TOLIC’s computation of net earnings of \$40,616,639 for the years 1988 through 2000 based on the use of the BOY methodology is correct.”

The TOLIC then went on to quote the pre-revision CAS 413.50(c)(7) which states:

“Fund income and expenses shall be allocated to the segment in the same proportion that the assets allocated to the segment bears to total fund assets as of the beginning of the period (emphasis added by TOLIC) for which fund income and expenses are being allocated.”

For the review period covering 1996 through 2000, TOLIC stated:

“The revised CAS 413 was never made applicable to TOLIC’s contract for plan years 1996 through 2000 as the OIG asserts. (OIG Rep. at 6.) As you are aware, Medicare Part B contracts are not generally subject to CAS (i.e. they are not CAS-covered). Thus, a revised CAS provision would not become a requirement of the contract unless it was

specifically made so by a contract (sic) amendment or other formal action by HHS. TOLIC has reviewed its contract files and has no record of any such amendment or action. In the absence of such action, TOLIC was required to continue to apply CAS 413 as specified in the contract signed in November 1987.”

The TOLIC then requested that we revise our earnings and expenses finding that increased segment assets by \$1,236,313 to reflect its BOY methodology.

It should be noted that TOLIC did not take exception to our computation of Medicare segment contributions for the update of Segment Assets.

The TOLIC then disagreed with our findings concerning the adjustments it made to the January 1, 2001 Medicare segment assets for the TARRP. The TOLIC also took issue with our findings concerning benefit payments made after January 1, 2001.

First, TOLIC took exception to our disallowance of the TARRP, which increased segment assets by \$4,406,089. The TOLIC stated:

“We do not agree that the assets for the Medicare segment should be increased for the pension costs incurred for TARRP. Rather, we believe that the costs incurred by TOLIC were reasonable and prudent to retain employees for the Medicare contract through its completion and are allowable pension costs under FAR 31.205-6(j), Pension Costs.”

The TOLIC also claimed that the TARRP should be an allowable cost based on communications it had with its CMS¹ contracting officer. The TOLIC stated:

“Thus, throughout February and March of 2001 TOLIC repeatedly and clearly informed HCFA that the company intended to incur costs in connection with TARRP to the benefit of Medicare. At no time during the procurement process did HCFA inform TOLIC that the agency disagreed with the company’s expressed intention to use TARRP to retain qualified Medicare employees both during performance of TOLIC’s contract and under the subsequent performance of TOLIC’s successor contract.”

The TOLIC then claimed that it implemented the TARRP based on the CMS’s conduct. The TOLIC also claimed that based on this conduct, CMS should reimburse all costs associated with the TARRP. The TOLIC stated:

“In sum, TOLIC relied to its detriment on HCFA’s conduct that was clearly designed to induce continued performance. For its part HCFA knew or should have known that, contrary to its representations, it was in fact very likely that the contract workload would be awarded pursuant to a ”turn-key” arrangement. Yet HCFA failed to so inform TOLIC...HCFA is bound by its representations to TOLIC regarding its intended

¹The TOLIC consistently used HCFA in its response to our draft report. Our use of CMS is synonymous with TOLIC’s use of HCFA.

procurement and its desired retention of TOLIC employees until contract transition was completed... Thus, all costs associated with the payments under TARRP are allowable and must be reimbursed by HCFA under TOLIC's contract."

In its final argument concerning the allowability of the TARRP, TOLIC disagreed with our interpretation of FAR 31.205-6(l). It believed that this provision was implemented to stop contractors from offering extraordinary payments to company executives without providing a similar benefit to all company employees. The TOLIC then stated that the TARRP was available to all employees of the Medicare segment and was, therefore, allowable.

The TOLIC also took exception to the disallowance of four participants that had been incorrectly included in its qualified pension plan. The TARRP liabilities for these four participants totaled \$258,873. The TOLIC, therefore, requested that we allow the \$258,873 of liabilities for the four TARRP annuitants and the \$4,406,089 of TARRP lump-sum payments. As a result, TOLIC requested that we revise our report and reduce the segment assets by \$4,664,962 (\$4,406,089 + \$258,873).

The TOLIC also disagreed with our findings concerning adjustments made to the January 1, 2001 Medicare segment assets for monthly annuity and lump-sum payments made after that date. The TOLIC stated that it provided additional documentation that not only removed our \$18,137 finding in its entirety, but also increased its adjustment to its update of segment assets by \$11,854. It, therefore, requested that we revise our draft report and decrease segment assets by \$29,991 (\$18,137 + \$11,854).

Next, TOLIC took exception to our finding concerning its purchase of an annuity contract. Subsequent to our draft report, TOLIC increased its final annuity liability contract price of \$32,864,127 to \$33,259,459. Therefore, TOLIC asserted that our allowable purchase price was \$3,424,543 less than its revised final contract price of \$33,259,459. The TOLIC disagreed with our finding for several reasons.

First, TOLIC did not agree with our use of FAR 31.205-19, which governs insurance costs, to determine the allowability of the annuity contract it purchased. The TOLIC also argued that it did not purchase self-insurance. In fact, TOLIC argued that it had not purchased insurance at all. The TOLIC's contention was that it had simply purchased another type of annuity from itself based on a competitive bid process. The TOLIC asserted that the entire annuity purchase contract was a pension cost rather than an insurance cost and, therefore, not applicable to the above FAR. The TOLIC based its opinion on FAR 2.101(b):²

"Insurance, as used in this part, means a contract which provides that for a stipulated consideration, one party undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event..."

²FAR 2.101(b) was formerly located at FAR 28.001.

Also, TOLIC once again asserted that it made a decision based on discussions with the Federal Government. The TOLIC points to a discussion between its actuary and the CMS actuary that was held:

“...for the express purpose of confirming TOLIC’s course of action in proceeding with the competitive award of a terminal funding contract.”

The TOLIC understood from the CMS actuary that TOLIC could purchase the contract from itself if competitively bid. In addition, the annuity contract would not necessarily have to be awarded based on the lowest bid.

The TOLIC also claimed that the contract was awarded based on its own analysis and on the advice of a consulting firm it hired to analyze the bids. The TOLIC’s contention was that the lowest bid, submitted by Principal Life Insurance Company, was unrealistic. The TOLIC stated:

“In Transamerica’s judgement...Principal would have been unable to cover a significant number of indirect costs, including profit, statutory reserve strain, investment expense, maintenance expense, acquisition expense, asset default expense, and mortality improvement.”

The TOLIC also cited the consulting firm it hired:

“...that the price bid by Principal was so low...as to call into question whether Principal actually understands the complexity of this case and has bid correctly.”

The TOLIC went on to state:

“All analyses pointed to the same conclusion, namely that Principal’s bid price was erroneously low. In TOLIC’s judgment, it was so low as to be unrealistic. Principal’s price was illusive, i.e., it was not as it appeared and actually would not have been the lowest bid price had other factors necessary for contract performance been considered. Thus, by declining to accept Principal’s unrealistic bid price after a rational, purposeful, and predictable bidding process, TOLIC was exercising its fiduciary duty to HCFA and was protecting the public fisc from inappropriate and unsound expenditure.”

The TOLIC then stated that it accepted its own bid because it was reasonable, realistic, and competitively priced. The TOLIC also stated:

“TOLIC acted the way any prudent business would in contracting for a service-it considered price, experience and familiarity with the services to be provided in making its decision. There is no indication that its decision was in any way arbitrary or unreasonable.”

The TOLIC believed it had acted reasonably and that the entire cost of the annuity contract was allowable. As a result, TOLIC requested that we revise our draft report finding and allow the entire contract cost of \$33,259,459.

Finally, TOLIC contended that the original segment closing date of January 1, 2001 was no longer appropriate since market conditions had created an inequitable financial situation for TOLIC. It claimed that the market dropped 15.25 percent for the period January 1, 2001 to September 30, 2001. As a result, TOLIC suggested a new segment closing date of September 30, 2001 and stated:

“TOLIC maintains that the OIG should not use January 1, 2001 as the valuation date for TOLIC’s pension assets. TOLIC believes that, based on equitable considerations arising from the fact that TOLIC could not arrive at an accurate determination of its potential pension fund liability until Fall 2001, and from the dramatic change in the U.S. economy in the year 2001, its pension segment assets should be valued as of September 30, 2001 instead of January 1, 2001.”

The TOLIC further stated:

“The use of January 1, 2001 as the date for determination of the market value of the Medicare segment assets produces a result that is inequitable, i.e., one that is unfair to TOLIC. Such a result would require the company to reimburse the government from its own funds for millions of dollars in pension assets, which, for reasons beyond the control of TOLIC, have evaporated since that date.”

Regarding the new segment closing date, TOLIC stated:

“September 30, 2001 is the appropriate date to evaluate the value of segment assets, the Medicare segments’ final actuarial accrued liability, and any resulting excess because TOLIC’s liability was not completely determined until approximately that date. On January 10, 2001, TOLIC partially satisfied the pension liability with a transfer of \$32,121,000 in pension assets to the annuity purchased from Transamerica’s Retirement Services. However, additional funds were subsequently required to complete the funding as additional information regarding the final amount of the liability was developed. These additional transfers took place in the amounts of \$824,616 on July 6, 2001 and \$313,843 on November 1, 2001 to fund a total liability of \$33,259,459. Moreover, TOLIC did not become aware that the OIG’s recommendation for remittance to the government would amount to some \$20 million for excess pension assets until late September 2001 and, as a result, could not, prior to that date, commence making arrangements to address the recommended payment.”

The TOLIC asserted that the CAS 413(c)(12) allowed for the changing of the segment closing date. Specifically, TOLIC quoted the section of the CAS that states:

“(iii) the calculation of the difference between the market value of the assets and the actuarial accrued liability shall be made as of the date of the event (e.g., contract termination, plan amendment, plant closure) that caused the closing of the segment, pension plan termination, or curtailment of benefits. If such a date is not readily determinable, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date.”

Based on this argument, TOLIC stated that segment assets must be reduced (emphasis added) by an additional \$1,684,708.

It was TOLIC’s contention that except for our computation of the Medicare segment contributions, which reduced segment assets, we should amend the draft report to reflect its: (1) asset rollup, (2) adjustments to that rollup, (3) calculation of its new final segment liability, and (4) revised segment closing date and corresponding reduction in segment assets. In total, TOLIC’s computations reduced the excess segment asset finding from \$20,227,001 to \$9,362,556.

OIG’s Response

Our comments are summarized in the following paragraphs. The CMS Office of the Actuary’s detailed comments on TOLIC’s response are presented in Appendix C.

We do not agree with any of TOLIC’s suggested revisions concerning the Medicare segment asset update, adjustments to the January 1, 2001 segment assets, computation of the final Medicare segment liabilities, and the settlement date. The TOLIC has not presented any verifiable documentation that would cause us to reconsider our findings. Also, TOLIC arbitrarily and incorrectly interpreted the CAS in an attempt to reduce the sum total of our findings.

First, TOLIC disputed some of the findings of our Medicare segment asset update by providing additional documentation for benefit payments and by attempting to justify the change in its earnings and expenses allocation methodology. However, TOLIC concurred with our allocation of contributions to the Medicare segment (the only calculation in our update that actually reduced segment assets).

The TOLIC provided documentation to claim an additional \$51,344 in benefit payments. We cannot accept the documentation because we have no way of verifying the participants that received the payments. Both the names and the social security numbers have been blocked out. Therefore, we cannot give credit for these additional payments.

Regarding TOLIC’s attempt to justify the change in its established allocation methodology, we disagree with its assertions. We maintain our position that the “average value of assets” was the appropriate methodology because it was both consistent with and satisfied the requirements of the CAS. Additionally, prior approval for a change from the “average value of assets” methodology was not received from CMS.

We disagree with TOLIC's contention that the adjusted Medicare segment assets as of January 1, 2001 were \$44,306,723 instead of \$50,061,918 (a reduction of segment assets by \$5,755,195). Not only did TOLIC fail to provide any verifiable information for the additional benefit payments it wanted us to consider, it also failed to convince us that its change in allocation methodology was appropriate. We, therefore, maintain that Medicare segment assets as of January 1, 2001 were \$50,061,918.

Next, TOLIC disputed our findings concerning the adjustments to the January 1, 2001 Medicare segment assets. These adjustments were related to the TARRP payments and qualified plan benefit payments made after January 1, 2001. However, we have found nothing in TOLIC's arguments or documentation that would cause us to reconsider our findings.

We disagree with TOLIC's assertions concerning the TARRP. The TOLIC incorrectly assumed that FAR 31.205-6(l) applies to only golden parachute severance packages for top-level executives. In fact, this provision covers all employee severance packages and not just those for upper management. We continue to maintain our position that the TARRP was implemented as the result of a change in contractor and that the program was in excess of TOLIC's normal severance package. Therefore, our opinion remains that FAR 31.205-6(l) is applicable to the TARRP.

We also disagree with TOLIC's argument that the TARRP was allowable based on the actions of CMS. The TOLIC supplied its teleconference notes and correspondence with CMS concerning the TARRP. However, we have found nothing in TOLIC's notes or correspondence that would cause us to reconsider the TARRP's allowability. We also have not found a formal request of approval for the TARRP. To the contrary, we have found documentation that refutes TOLIC's assertions.

In fact, based on information and correspondence received from CMS, TOLIC knew or should have known that the allowability of the TARRP was questionable. In May 1999, TOLIC received a memorandum from CMS that addressed the allowability of severance payments made by an outgoing contractor. One of the criteria for allowability states:

“The contractor shall have an established, written severance policy in place and it **must** (emphasis added) be found to be reasonable by the Government.”

The TARRP was a new plan and had not been approved by CMS. As late as June 2000, CMS staff informed TOLIC's Vice President that “they were at risk since they hadn't requested or received our approval” for the TARRP. We have found other correspondence from CMS which clearly shows that as late as September 2000, approval for the TARRP had not been granted by CMS. This letter also clearly shows that CMS was questioning the reasonableness of the TARRP as proposed by TOLIC.

In our opinion, TOLIC was aware that the TARRP would not be allowable for Medicare reimbursement without prior approval and still chose to implement the program. The TOLIC should have done what any reasonable and prudent Medicare contractor would have done. The

TOLIC should have waited to receive approval from CMS before implementing the TARRP. We, therefore, maintain our position that the TARRP liabilities of \$4,664,962 are unallowable in their entirety.

Regarding TOLIC's assertions about the qualified plan benefit payments made after January 1, 2001, we were unable to verify the additional claims. Like the documentation sent to claim additional benefit payments in the update of Medicare segment assets, the documentation for these adjustments had been altered to the point that we could not verify the participant. We, therefore, reject TOLIC's claim for additional benefit payments totaling \$29,991 for 2001.

Next, we do not agree with TOLIC's arguments concerning our findings related to its annuity contract. We maintain that the liability contract is insurance and the FAR 31.205-19(b) does apply. Additionally, we maintain that by accepting its own bid, TOLIC failed in its fiduciary responsibility to the Government to safeguard Government assets.

We found no justification for TOLIC's assumptions concerning Principal's bid. According to CMS's actuary, Principal Life Insurance Company is a well-established company with a long history of selling annuity contracts. The actuary analyzed Principal's bid and found it to be a credible bid. Also, TOLIC's own bid advisor (Brentwood Asset Advisor) stated that Principal was one of 11 "safest available" insurance companies. Brentwood summarized its analysis of Principal by stating:

"...Annuitants' and policyholders' excellent long-term security reflects the company's efficient, technology-based operations and its disciplined financial and investment management."

Clearly, per the CMS actuary's and Brentwood's analysis, there was no reason to assume that Principal would not be able to protect participant liabilities had it been awarded the annuity contract. We, therefore, maintain that Principal's bid should have been accepted and that the allowable Medicare segment final liabilities were \$29,834,916.

Finally, we disagree with TOLIC's claim that the use of the January 1, 2001 closing date created an inequitable outcome for TOLIC. The TOLIC's Medicare operations clearly ended November 30, 2000. At TOLIC's request, we agreed to a January 1, 2001 settlement date. At no time during our discussions with TOLIC, even through the issuance of the draft report, did it express concern with the agreed upon settlement date. It was not until TOLIC responded to the draft report that the closing date became an issue.

In addition to TOLIC's claim of an inequitable outcome, TOLIC's interpretation of CAS 413(c)(12) is arbitrary at best. The TOLIC underscored the section of this provision that deals with undeterminable closing dates and inequitable calculations. However, as disclosed above, TOLIC suggested the settlement date and we accepted its recommendation. If the market had dropped by the settlement date, our report would have reflected that reduction in segment assets. However, there were excess pension assets for the segment and we, therefore, recommend those excess funds be remitted to the Government.

Additionally, we disagree with TOLIC's suggested use of September 30, 2001 because of the additional liability transfers totaling \$1.1 million that took place in July and November of 2001. It should be noted that at no time during our discussions with TOLIC did it mention these additional liabilities. Also, while TOLIC presented a letter showing the \$33,259,459 for the annuity contract purchase, it did not provide participant documentation for the additional \$1.1 million of liabilities. We, therefore, reject the additional liabilities due to TOLIC's representations and lack of proper documentation to substantiate its claims.

We also disagree with TOLIC's assertion that its annuity contract purchase was incomplete and, therefore, the settlement was incomplete. Prior to the release of the draft report, TOLIC represented to us that its liability insurance purchase was finalized at \$32,864,127.

Regarding TOLIC's assertions about the drop in market values in September 2001, we disagree. While TOLIC presented a letter stating that its investments had dropped by 15.25 percent, the September date was 9 months after TOLIC left the Medicare program. Also, if the market had gained 15.25 percent in that time period, we doubt that TOLIC would have suggested a change of date due to the "inequity" that the original settlement date would have created for the Government.

Finally, we reject TOLIC's argument that it was unaware of the potential magnitude of our findings. In a September 2001 teleconference, TOLIC's staff stated that it told management that our report could result in a repayment to the Government totaling approximately \$20 million. The TOLIC's management was fully aware of the potential outcome of our review and could have taken action to protect the company from this situation. We, therefore, reject all of TOLIC's assertions concerning a change of settlement date.

In summary, except for TOLIC's agreement with our computation of contributions to the Medicare segment, we disagree with TOLIC's response in its entirety. TOLIC has not provided any documentation or cited any regulations to cause us to reconsider our findings. Likewise, their arbitrary interpretations of the CAS are without merit. Therefore, our position has not changed and we recommend that TOLIC remit \$20,227,001 in excess Medicare pension assets to the Federal Government.

INSTRUCTIONS FOR AUDITEE RESPONSE

Final determinations as to actions to be taken on all matters reported will be made by the CMS action official identified below. We request that you respond to the recommendation in this report within 30 days from the date of this report to the CMS action official, presenting any comments or additional information that you believe may have a bearing on final determination.

In accordance with the principles of the Freedom of Information Act, 5 U.S.C. 552, as amended by Public Law 104-231, OIG, OAS reports are made available to the public to the extent information contained therein is not subject to exemptions in the Act. (See 45 CFR part 5.) As such, within 10 business days after the final report is issued, it will be posted on the worldwide web at <http://oig.hhs.gov/>.

Sincerely,

A handwritten signature in black ink, appearing to read "James P. Aasmundstad".

James P. Aasmundstad
Regional Inspector General for
Audit Services, Region VII

Enclosures

CMS Action Official

Ms. Elizabeth Abbott
Regional Administrator, Region IX
Centers for Medicare & Medicaid Services
75 Hawthorne Street, 4th Floor
San Francisco, California 94105-3903

APPENDICES

TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY
STATEMENT OF MEDICARE PENSION ASSETS
JANUARY 1, 1988 TO JANUARY 1, 2001

Description		Total Company	Other Segment	Medicare
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Assets as of January 1, 1988	<u>1/</u>	\$392,859,065	\$387,222,949	\$5,636,116
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Contributions	<u>2/</u>	17,898,775	17,150,368	748,407
Earnings	<u>3/</u>	34,299,902	33,784,573	515,329
Benefit Payments	<u>4/</u>	(6,323,923)	(6,281,982)	(41,941)
PBGC Premium	<u>5/</u>	(198,135)	(193,052)	(5,083)
Expenses	<u>6/</u>	(2,943,580)	(2,899,355)	(44,225)
Assets as of January 1, 1989		\$435,592,104	\$428,783,501	\$6,808,603

Contributions		18,833,012	18,118,388	714,624
Earnings		69,801,763	68,673,828	1,127,935
Benefit Payments		(7,656,610)	(7,611,754)	(44,856)
PBGC Premium		(368,128)	(358,992)	(9,136)
Expenses		(2,862,325)	(2,816,072)	(46,253)
Assets as of January 1, 1990		\$513,339,816	\$504,788,899	\$8,550,917

Contributions		22,630,160	21,649,707	980,453
Earnings		(6,507,562)	(6,394,720)	(112,842)
Benefit Payments		(12,349,893)	(12,297,420)	(52,473)
PBGC Premium		(373,968)	(363,840)	(10,128)
Expenses		(2,265,629)	(2,226,293)	(39,336)
Assets as of January 1, 1991		\$514,472,924	\$505,156,333	\$9,316,591

Contributions		16,852,989	15,943,682	909,307
Earnings		121,200,635	118,910,238	2,290,397
Benefit Payments		(14,444,690)	(14,371,722)	(72,968)
PBGC Premium		(388,544)	(377,280)	(11,264)
Expenses		(287,578)	(282,143)	(5,435)
Assets as of January 1, 1992		\$637,405,736	\$624,979,108	\$12,426,628

TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY
STATEMENT OF MEDICARE PENSION ASSETS
JANUARY 1, 1988 TO JANUARY 1, 2001

Description	Total Company	Other Segment	Medicare
Assets as of January 1, 1992	\$637,405,736	\$624,979,108	\$12,426,628
Contributions	14,861,694	14,341,439	520,255
Earnings	57,479,970	56,338,574	1,141,396
Benefit Payments	(16,758,111)	(16,646,192)	(111,919)
PBGC Premium	(468,787)	(454,290)	(14,497)
Expenses	(403,792)	(395,774)	(8,018)
Assets as of January 1, 1993	\$692,116,710	\$678,162,865	\$13,953,845
Contributions	12,600,115	11,448,368	1,151,747
Earnings	140,822,929	137,872,455	2,950,474
Benefit Payments	(19,543,951)	(19,374,161)	(169,790)
PBGC Premium	(493,202)	(478,154)	(15,048)
Expenses	(538,745)	(527,446)	(11,299)
Assets as of January 1, 1994	\$824,963,856	\$807,103,927	\$17,859,929
Contributions	9,751,333	8,831,626	919,707
Earnings	(3,274,646)	(3,201,191)	(73,455)
Benefit Payments	(28,281,556)	(28,072,596)	(208,960)
PBGC Premium	(509,143)	(494,665)	(14,478)
Expenses	(588,379)	(575,260)	(13,119)
Assets as of January 1, 1995	\$802,061,465	\$783,591,841	\$18,469,624
Contributions	0	0	0
Earnings	225,862,635	220,627,167	5,235,468
Benefit Payments	(25,166,523)	(24,827,291)	(339,232)
PBGC Premium	(493,335)	(479,503)	(13,832)
Expenses	(605,685)	(591,645)	(14,040)
Assets as of January 1, 1996	\$1,001,658,557	\$978,320,569	\$23,337,988

TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY
STATEMENT OF MEDICARE PENSION ASSETS
JANUARY 1, 1988 TO JANUARY 1, 2001

Description	Total Company	Other Segment	Medicare
Assets as of January 1, 1996	\$1,001,658,557	978,320,569	\$23,337,988
Contributions	0	0	0
Earnings	159,102,809	155,374,267	3,728,542
Benefit Payments	(26,470,702)	(26,121,716)	(348,986)
PBGC Premium	(473,765)	(459,933)	(13,832)
Expenses	(1,988,566)	(1,941,964)	(46,602)
Assets as of January 1, 1997	\$1,131,828,333	\$1,105,171,223	\$26,657,110
Contributions	0	0	0
Earnings	298,946,000	291,862,755	7,083,245
Benefit Payments	(28,397,758)	(28,045,897)	(351,861)
PBGC Premium	(472,131)	(458,299)	(13,832)
Expenses	(1,534,638)	(1,498,276)	(36,362)
Assets as of January 1, 1998	\$1,400,369,806	\$1,367,031,506	\$33,338,300
Contributions	0	0	0
Transfer To TOLIC	<u>7/</u> 3,722,462	3,722,462	0
Earnings	496,131,400	484,242,392	11,889,008
Benefit Payments	(37,485,650)	(37,026,083)	(459,567)
PBGC Premium	(482,885)	(468,540)	(14,345)
Expenses	(2,823,425)	(2,755,766)	(67,659)
Assets as of January 1, 1999	\$1,859,431,708	\$1,814,745,971	\$44,685,737
Contributions	0	0	0
Earnings	502,374,587	490,157,498	12,217,089
Benefit Payments	(37,044,623)	(36,575,080)	(469,543)
PBGC Premium	(467,647)	(451,972)	(15,675)
Expenses	(3,048,991)	(2,975,351)	(73,640)
Assets as of January 1, 2000	\$2,323,774,299	\$2,267,430,331	\$56,343,968

TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY
STATEMENT OF MEDICARE PENSION ASSETS
JANUARY 1, 1988 TO JANUARY 1, 2001

Description	Total Company	Other Segment	Medicare
Assets as of January 1, 2000	\$2,323,774,299	2,267,430,331	\$56,343,968
Contributions	0	0	0
Earnings	(227,411,087)	(221,854,558)	(5,556,529)
Benefit Payments	(55,778,731)	(55,285,416)	(493,315)
PBGC Premium	(483,683)	(468,008)	(15,675)
Expenses	(421,230)	(410,938)	(10,292)
Assets as of December 31, 2000	\$2,039,679,567	1,989,411,410	\$50,268,157
Adjustments	<u>8/</u> (206,239)	0	(206,239)
Adjusted Assets as of			
January 1, 2001	<u>9/</u> 2,039,473,328	1,989,411,410	50,061,918
Per TOLIC	<u>9/</u> 2,019,248,136	1,974,869,179	44,378,957
Asset Variance	<u>10/</u> \$20,225,192	\$14,542,231	\$5,682,961

FOOTNOTES

1. We determined the Medicare segment assets as of January 1, 1988 in our prior review of TOLIC's pension segmentation (A-07-91-00391). The amounts shown for the other segment represent the difference between the total company and the Medicare segment. All pension assets are shown at market value.
2. We obtained total contribution amounts from IRS Form 5500 reports. The TOLIC did not make contributions to the pension trust fund for plan years 1995 through 2000.
3. We obtained investment earnings from actuarial valuation reports. The TOLIC allocated their investment earnings based on their BOY assets. We allocated earnings based on the average value of assets as required by the CAS.
4. We obtained total benefit payments from actuarial valuation reports. We based the Medicare segment's benefit payments on actual payments to Medicare retirees.
5. The CMS Office of the Actuary computed the total plan Pension Benefit Guarantee Corporation (PBGC) premiums based on the number of total company participants.

TOLIC allocated their premiums based on the BOY assets. We allocated the premiums based on the average value of assets as required by the CAS.

TRANSAMERICA OCCIDENTAL LIFE INSURANCE COMPANY
STATEMENT OF MEDICARE PENSION ASSETS
JANUARY 1, 1988 TO JANUARY 1, 2001

6. Transamerica Corporation transferred the assets of Transamerica Airlines into the plan on March 31, 1998. These assets totaled \$3,722,462. Transamerica Airlines was not part of the Medicare segment and, therefore, none of the assets transferred to the segment.
7. The TOLIC adjusted its January 1, 2001 Medicare segment assets by TARRP payments of \$4,406,089 and benefit payments totaling \$224,376. We determined that the TARRP payments were unallowable in their entirety. We also determined that \$18,137 of the benefit payments for 2001 was unallowable. We, therefore, adjusted the January 1, 2001 Medicare segment assets by the remaining allowable benefit payments of \$206,239.
8. The adjusted assets represent our audited Medicare segment assets as of January 1, 2001 less the allowable benefit payments for 2001.
9. We obtained total asset amounts as of January 1, 2001 from TOLIC's update of Medicare segment assets.
10. The asset variance represents the difference between the OIG calculation of Medicare segment assets as of January 1, 2001 and the segment assets calculated by TOLIC.

POWELL
GOLDSTEIN
FRAZER &
MURPHY LLP

Transamerica Occidental Life Insurance Company's

Response

to the

Department of Health and Human Services,
Office of Inspector General, Office of Audit Services

Draft Report Entitled:

Audit of the Pension Plan at a Terminated Medicare Contractor,

Transamerica Occidental Life Insurance Company,

Dated December 2001

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Dated: February 14, 2002




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Transamerica Occidental Life Insurance Company,
Dated December 2001

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Transamerica Occidental Life Insurance Company's
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Transamerica Occidental Life Insurance Company,
Dated December 2001

by the

Office of Inspector General, Office of Audit Services
of the Department of Health and Human Services

February 14, 2002

Reference: CIN A-07-01-00125

I. Introduction

The OIG asserts that "[a]s of January 1, 1988, TOLIC correctly identified Medicare segment assets totaling \$5,636,116." (See Department of Health and Human Services, Office of Inspector General, draft report entitled "Audit of the Pension Plan at a Terminated Medicare Contractor, Transamerica Occidental Life Insurance Company," at 4 (hereafter "OIG Rep.")). The OIG asserts, however, that TOLIC's methodology in updating the Medicare segment assets from January 1, 1988 to January 1, 2001 "resulted in an understatement of Medicare segment assets of \$5,682,960." (OIG Rep. at 3.) The OIG asserts that the understatement of assets occurred because TOLIC: (1) overstated benefit payments by \$153,859; (2) overstated pension contributions by \$131,438; (3) understated earnings and expenses by \$1,236,313; (4) incorrectly reduced December 31, 2000 Medicare segment assets by lump sum payments of \$4,406,089 made under the Transamerica Retention and Retirement Program ("TARRP"); and (5) incorrectly reduced December 31, 2000 Medicare segment assets by \$224,376 instead of \$206,239 for monthly annuity and lump sum payments paid after year-end. (OIG Rep. at 3-4.) Thus, the OIG concludes that TOLIC's pension assets at January 1, 2001 of \$44,378,958 should be increased by \$5,682,960, resulting in pension assets of \$50,061,918.

First, TOLIC maintains that the only appropriate adjustments to its January 1, 2001 pension assets of \$44,378,957 are (1) a decrease of \$475,378 for overstated pension contributions, which includes \$131,438 of overstated pension contributions plus \$343,940 of accumulated earnings on those contributions; (2) an increase of \$414,998 for overstated benefit payments, which includes \$102,515 of overstated benefit payments plus \$312,483 of accumulated earnings on those benefit payments; and (3) a decrease of \$11,854 for additional monthly annuity and lump sum payments paid after year-end. These adjustments result in adjusted pension assets of \$44,306,723. (See Exhibit A.)

Second, the OIG reduced TOLIC's adjusted pension assets by \$29,834,916 which represents the lowest bidder's adjusted price for the annuity liability contract minus \$258,873 for annuity liability payments for the four participants incorrectly included. In contrast, TOLIC believes that its claimed pension annuity purchase cost of \$33,259,459 is allowable and that the

annuity purchase amount should not be reduced by \$258,873 because this amount was properly paid for the four TARRP participants who chose monthly annuity payments instead of lump sum payments under TARRP. Reducing TOLIC's adjusted pension assets of \$44,306,723 by \$33,259,459 results in \$11,047,264 in pension segment assets as of January 1, 2001.

Finally, TOLIC maintains that, based on equitable considerations arising from the fact that TOLIC could not arrive at an accurate determination of its potential pension fund liability until Fall 2001, and from the dramatic change in the U.S. economy in the year 2001, its pension segment assets should be valued as of September 30, 2001 instead of January 1, 2001. The value of TOLIC's Medicare segment pension assets experienced a -15.25% change from January 1, 2001 to September 30, 2001.

Thus, by TOLIC's calculations, TOLIC's pension assets of \$11,047,264 (which we arrived at by reducing TOLIC's adjusted pension assets of \$44,306,723 by its annuity liability purchase amount of \$33,259,459) should be adjusted by a \$1,684,708 decrease in pension asset value, resulting in excess pension assets of \$9,362,556 owed to the government. (See Exhibit A.)

II. Medicare Asset Base as of January 1, 1988 Updated to January 1, 2001¹

TOLIC's position regarding each of the OIG's recommended adjustments is set out below.

A. Benefit Payments

The OIG asserts that "due to the incorrect identification of retirement benefit payments made to Medicare segment participants [from 1988 to 2000], TOLIC understated segment assets" by \$153,859. (OIG Rep. at 4.) The OIG then asserts that correction of this error "result[s] in a net increase of \$153,859 in the segment assets." (OIG Rep. at 4.)

TOLIC's benefit payments included in the draft report were based on data available at the time and in some cases were based on estimates. Subsequent to the audit report, the OIG provided TOLIC with the data elements the OIG believed it could not confirm during the audit. (Exhibit B.) TOLIC reviewed each of these items and identified support for \$51,344 of the \$153,859 in questioned payments. Thus, the amount questioned by the OIG should be reduced by \$51,344 resulting in overstated benefit payments of \$102,515:

<u>Questioned Benefit Payments</u>	<u>Amount Paid</u>
(1) OIG asserts that Social Security Number A received 11 payments in 2000. Backup is provided to support one additional payment in 2000 of \$989.59, for a total of 12 payments.	\$ 989.59

¹ For the convenience of the reader, the major headings in the remainder of this Response are the same as the headings used by OIG in its draft report.

- | | | |
|-----|---|----------------------------------|
| (2) | OIG asserts that Social Security Number B documentation could not be obtained during the audit. Backup is provided to support these annuity payments of \$48,535.74. | \$ 48,535.74 |
| (3) | OIG asserts that Social Security Number C received 11 payments in 1999. Backup is provided to support one additional payment in 1999 of \$865.34, for a total of 12 payments. | \$ 865.34 |
| (4) | OIG asserts that Social Security Number D received 11 payments in 2000. Backup is provided to support one additional payment in 2000 of \$547.12, for a total of 12 payments. | \$ 547.12 |
| (5) | OIG asserts that Social Security Number E received one payment in 1999. Backup is provided to support two payments in 1999 totaling \$406.58. | <u>\$ 406.58</u>
\$ 51,344.37 |

(Exhibit A is a chart showing these payments.) Attached to it is the backup documentation for each of these employees.) Since TOLIC overstated the benefit payments by \$102,515 (\$153,859 - \$51,344 = \$102,515), a related adjustment of \$312,483 to increase assets for earnings related to these benefit payments has also been made. (See Exhibit A, wherein the adjustment is calculated.)

B. Pension Contributions

The OIG asserts that "TOLIC's update methodology did not equitably assign pension contributions to the Medicare segment. As a result, TOLIC overstated segment assets by \$131,438." (OIG Rep. at 4.) TOLIC does not challenge the OIG's position on this matter. This adjustment has a total impact of reducing the January 1, 2001, pension asset value by \$475,378 (\$131,458 of overstated pension contributions, plus \$343,940 of overstated earnings on those contributions is \$475,378.) (See Exhibit D, wherein the adjustment is calculated.)

C. Earnings and Expenses

The OIG asserts that "TOLIC's update methodology incorrectly allocated investment earnings and expenses ... based on a ratio of the beginning of the year (BOY) Medicare segment assets to total company assets." (OIG Rep. at 5.) Under TOLIC's methodology, "TOLIC computed net earnings of \$40,616,639 for the years 1988 through 2000." (OIG Rep. at 5.) The OIG asserts that instead TOLIC should have used the average value of assets methodology at all times. (OIG Rep. at 6.) Using the average value of assets methodology, the OIG computed net earnings of \$41,852,952 for the years 1988 through 2000. (OIG Rep. at 6.) Thus, the OIG concludes that TOLIC's Medicare segment assets should be increased by the difference between the two amounts, \$1,236,313. (OIG Rep. at 6.)

TOLIC disagrees with the OIG's position. TOLIC utilized the average value of assets methodology through 1987; in fact, the OIG relied on this method in its earlier segment audit, entitled "Audit of Medicare Contractor's Segmented Pension Cost, Transamerica Occidental Life Insurance Company," dated August 19, 1991. However, the CAS 413 provision incorporated into TOLIC's November 1987 contract for fiscal year 1988 required the use of the BOY methodology. Thus, TOLIC's computation of net earnings of \$40,616,639 for the years 1988 through 2000 based on the use of the BOY methodology is correct.

TOLIC's Medicare Part B contract signed in November 1987 required the use of the original CAS 413. That contract includes Appendix B (10-87) which is captioned:

(Intermediary, Plan and Carrier Agreements/Contracts)
Principles of Reimbursement for Administrative Costs

(Exhibit E, at Appendix B, page 1.)

Item XVI to Appendix B addresses Pension Costs. It states that CAS 413 as described in Appendix B is the CAS provision applicable to the contract:

CAS 413 shall be interpreted and applied as specified herein.
Neither the Secretary nor the contractor shall seek to apply a different interpretation of the provisions of the CAS addressed below, consistent with the applicable statutes and regulations, with respect to this or any prior contract period.

(Exhibit E, at Appendix B, page 9.)

Furthermore, Paragraph 4 of Item XVI to Appendix B specifies that pension assets shall be adjusted in accordance with CAS 413.50(c)(7):

Determining segment assets following initial allocation: For each pension plan year following the initial asset allocation required by this Item XVI, the pension assets allocated to each Medicare Segment shall be adjusted in accordance with CAS 413.50(c)(7).

(Exhibit E, at page 11.) CAS 413.50(c)(7) in effect in 1987 and 1988 required the BOY method of allocation:

After the initial allocation of assets, the contractor shall maintain a record of the portion of subsequent contributions, income, benefit payments and expenses attributable to the segment and paid from the pension fund; income and expenses shall include a portion of any investment gains and losses attributable to the assets of the pension fund. Fund income and expenses shall be allocated to the segment in the same proportion that the assets allocated to the segment bears to total fund assets as of the beginning of the period for which fund income and expenses are being allocated.

(Exhibit F, 4 C.F.R. § 413.50 (c)(7) (emphasis added).)

We do not believe the OIG should object to the allocation method that the government incorporated in the contract.

The revised CAS 413 was never made applicable to TOLIC's contract for plan years 1996 through 2000 as the OIG asserts. (OIG Rep. at 6.) As you are aware, Medicare Part B contracts are not generally subject to CAS (*i.e.* they are not CAS-covered). Thus, a revised CAS provision would not become a requirement of the contract unless it was specifically made so by a contract amendment or other formal action by HHS. TOLIC has reviewed its contract files and has no record of any such amendment or action. In the absence of such action, TOLIC was required to continue to apply CAS 413 as specified in the contract signed in November 1987. As discussed above, that CAS provision required the BOY methodology.

TOLIC requests that the OIG amend its draft report to remove the \$1,236,313 increase in Medicare assets it calculated based on the use of the average value of assets methodology for years 1988 through 2000.

D. Adjustments to December 31, 2000 Medicare Segment Assets

1. Transamerica Retention and Retirement Program ("TARRP")

The OIG asserts that \$4,406,089 TOLIC claimed for TARRP payments is unallowable because "[t]he TARRP provided special compensation for TOLIC employees in excess of TOLIC's normal severance plan. Additionally, TARRP was introduced in connection with a change in company ownership." (OIG Rep. at 8.) The OIG also questions \$258,873 in annuity costs for four Transamerica Retention Retirement Program (TARRP) participants who chose to receive monthly annuity payments instead of lump sum payments under TARRP.² (OIG Rep. at 9.) Thus, the OIG concludes that TARRP costs are unallowable under FAR 31.205-6(l). As a result, the OIG adds \$4,406,089 to Medicare Segment assets, and deducts \$258,873 from the allowable annuity purchase amount.

We do not agree that the assets for the Medicare segment should be increased for the pension costs incurred for TARRP. Rather, we believe that the costs incurred by TOLIC were reasonable and prudent to retain employees for the Medicare contract through its completion and are allowable pension costs under FAR 31.205-6(j), Pension Costs. We also do not agree that \$258,873 should be deducted from the allowable annuity liability purchase amount. These annuity payments are allowable TARRP pension costs for these four TARRP participants.

² As previously noted, in its discussion of the allowability of the annuity liability purchase amount the OIG Report denies \$258,873 in annuity liability payments for the four participants incorrectly included. However, the four participants referenced were TARRP participants who chose monthly annuity payments instead of lump sum payments under TARRP. (Exhibit G.) Therefore, we discuss this here in connection with TARRP.

a. Both TOLIC and HCFA Intended for TOLIC to Utilize TARRP to Ensure Continued Service and a Smooth Transition to the Replacement Contractor

1. TOLIC Incorporated TARRP Into a Carefully Crafted Employee Retention and Retirement Plan:

TOLIC's contract performance responsibilities did not cease with its decision to leave the Medicare business. The company therefore established as a crucial objective the retention of qualified employees to complete the work of the contract, the required transition, and termination settlement proposal. TOLIC achieved its objective in significant part through the use of TARRP. Utilizing TARRP, the Medicare Division was able to establish termination dates for employees based on the Division needs and schedules for completing the work of the Medicare contract. The result was that the TARRP plan produced important benefits for both TOLIC and HCFA. Among these benefits was TOLIC's ability to maintain Medicare Part B service standards until the transition to the replacement or successor contractor (who was to be determined on the basis of new procurement) had been completed. TOLIC adopted this posture because it was committed to superior performance standards, the Medicare program, and its loyal employees. In so doing, TOLIC relied on HCFA's assertions regarding its plans to transition the Medicare work and reasonably assumed that HCFA would honor the terms of its contract as they related to reimbursement for costs paid under an established and approved retention and retirement program, i.e., TARRP.

2. HCFA Represented to TOLIC That the Successor Contract Would Not Be Awarded Pursuant to a Turn-key Arrangement

TOLIC had no reason to doubt HCFA's stated intention as to the manner in which it would procure the relevant Medicare services and its repeated assertions that the Southern California and Six States Medicare Integrity Program contracts would not be awarded pursuant to a "turn-key" arrangement. Working in conjunction with HCFA to retain employees as long as possible and thus facilitate transition to the (at that point unknown) replacement contractor, TOLIC represented to its Medicare contract employees that an employee would be eligible for TARRP if his or her job were eliminated and a new job was not unconditionally offered by the replacement contractor. TOLIC made these representations to its Medicare employees pursuant to a plan carefully crafted by TOLIC's Vice President and Chief Medicare Officer, Mr. George Garcia. The plan was aimed at optimizing the possibility that the Medicare program would retain the services of qualified employees at least through the period of performance of TOLIC's contract and, if possible, under the contract awarded to TOLIC's then unknown successor contractor. HCFA was fully aware of this plan and TOLIC's open commitment of resources to it, including TOLIC's representation to its Medicare contract employees.

3. From the Outset, TOLIC Explicitly and Repeatedly Informed HCFA of its Intention to Utilize TARRP as a Key Element of Its Employee Retention Program

Prior to discussing TARRP with TOLIC's Medicare employees, Mr. Garcia repeatedly informed HCFA of the company's intention to provide TARRP as a means of retaining qualified Medicare employees. He did so in three separate conference calls with the Contracting Officer, which took place, respectively on February 16, February 18 and February 23, 2000. Mr. Garcia's notes of the February 16 conference call state that the Contracting Officer informed TOLIC that, while the agency "[w]ould want to keep quality staff" for the successor contractor, the agency would "not do what was done in Iowa (turnkey)" and noted that retention policy would be discussed in the next conference call. (Exhibit H, at page 5.) The Contracting Officer thus indicated to TOLIC that, although HCFA "would want to keep quality [TOLIC] staff," it would not enter into a turn-key arrangement. TOLIC was thus given to understand that its employees would not automatically be able to retain their jobs and transfer in place to the successor contractor.

Mr. Garcia's notes of the February 18 conference call show that the parties continued to address the intense interest of both TOLIC and HCFA in the retention of qualified employees:

Severance Issue:

- In existing policy
- Severance policy
- Retention (retention) performance bonuses – need to develop
- Past policies. Amount of bonus is up to us.
 - Usually a percentage of salary
 - Does it apply to everyone and/or key staff (it would apply to everyone for TOLIC. Would evaluate different amounts for key staff).
 - Based on prior experience, HCFA has seen a range from 10% of salary duration transition (defined as salary earned from contract termination notice to date of transition).
 - If job market is tight – has seen 20%.
 - To a maximum of 25% for key staff. (Emphasis added).

Severance [TARRP] Package:³

- Would not apply to people offered comparable employment (similar job, close proximity, with same salary).

³ Mr. Garcia sometimes used the term "severance" with reference to TARRP

(Exhibit H, at page 3.)

On February 23, the parties discussed the "issue of requiring the employment of qualified staff" by the successor contractor. (Exhibit H, at page 1.) HCFA informed TOLIC that such employment was "not a requirement" but noted that "TOLIC's diversified staff is a plus" for the successor contractor. (Exhibit H, at page 1.) TOLIC informed HCFA in response that the company would "[t]ell employees [they would be] eligible for TARRP [if] not hired by incoming contractor." (Exhibit H, at page 1.) HCFA did not object to TOLIC's statement of its plan regarding TARRP as part of its retention plan.

By letter dated March 16, 2000, Mr. Garcia followed up his statements made in the three conference calls. The letter provided the Contracting Officer a clean and concise written description of the company's plan to retain qualified employees and, as well, a discussion of the reasons the company believed the plan to be necessary:

Mr. John Barton
Contracting Officer

Re: TOLIC Retention Bonus Plan Policy

Dear John:

I apologize for not getting this to you sooner, but I wanted to make sure that it is a comprehensive document.

Retention of current staff through transition to a new contractor will be a challenge for us. Offering our current experienced and skilled staff incentives to stay is a must in the current employment environment. For example, the Los Angeles Times last Saturday published an article, on the front page, about the current unemployment rate and the fact that California is enjoying a 30-year low in unemployment. The unemployment figure for Los Angeles County was 5.5%.

* * *

All of this leads to an environment which will pay premium salaries for qualified individuals. Our Medicare staff is well versed in many skills and as such would be prime staff for other companies in the area.

Lack of proper resources will impact our service to beneficiaries and providers. This will tar our image and HCFA's and be difficult and expensive to recover from. This is something neither TOLIC nor HCFA wants to see happen.

Therefore, we must implement retention and severance policies, which will encourage people to stay through transition. Our

TARRP severance policy currently in place provides a bridge to future employment when jobs are eliminated. The Retention Bonus Plan policy we have developed is intended to maintain critical performance standards and make a maximum number of skilled Medicare personnel available to the new contractor.

* * *

Sincerely,

George E Garcia
Vice President and
Chief Medicare Officer

(Exhibit I, at page 2 (emphasis added).)

The above letter was the final step in TOLIC's consistent course of conduct prior to the award of the contract work through which it informed HCFA of its plans with regard to TARRP. Thus, throughout February and March of 2001 TOLIC repeatedly and clearly informed HCFA that the company intended to incur costs in connection with TARRP to the benefit of Medicare. At no time during the procurement process did HCFA inform TOLIC that the agency disagreed with the company's expressed intention to use TARRP to retain qualified Medicare employees both during performance of TOLIC's contract and under the subsequent performance of TOLIC's successor contract.

In sum, TOLIC relied to its detriment on HCFA's conduct that was clearly designed to induce continued performance. For its part HCFA knew or should have known that, contrary to its representations, it was in fact very likely that the contract workload would be awarded pursuant to a turn-key arrangement. Yet HCFA failed to so inform TOLIC. *See Solar Turbines Inc. v. United States*, 1997 U.S. App. LEXIS 12431, *14 (Fed. Cir. 1986). HCFA is bound by its representations to TOLIC regarding its intended procurement and its desired retention of TOLIC employees until contract transition was completed. *Bell Helicopter Co.*, ASBCA No. 1776, 74-1 BCA 10,441; *Kozak Micro Sys., Inc.*, GSBGA No. 10519, 91-1 BCA 23,342, *recon. denied*, 91-1 BCA 23,593. Thus, all costs associated with the payments under TARRP are allowable and must be reimbursed by HCFA under TOLIC's contract.

b. The TARRP Is Allowable Under the FAR as a Pension Plan

As you are aware, the TARRP benefit is part of The Retirement Plan for Salaried U.S. Employees of Transamerica and Affiliates. FAR 31.205-6(j) provides for the allowability of pension plan costs. In this case, the pension costs for TARRP have been measured and paid to participants or funded with the settlement of the Medicare segment pension liabilities. The TARRP costs reflect payments and settled liabilities that have now been paid to participants or funded to produce allowable pension costs under the criteria of FAR 31.205-6(j).

The OIG asserts that TARRP costs are unallowable under FAR 31.205-6(1)(2) as:

Payments to employees under plans introduced in connection with a change in control (whether actual or prospective) in the management control over, or ownership of, the contractor or a substantial portion of its assets, in which those employees receive special compensation, which is contingent upon the employee remaining with contractor for a specified period of time.

(OIG Rep. at 7-8.)

FAR 31.205-6(l) was promulgated in 1988 to address the costs of so-called "golden parachutes" and "golden handcuffs." (See Federal Acquisition Circular 84-35, Item II, Federal Register Vol. 53, No. 63, April 1, 1988) A significant issue being addressed by the revised cost principle was extraordinary payments made by companies to retain employees in connection with a change in ownership – a "golden handcuff." Specifically, FAR subsection 31.205-6(l)(2), cited in the OIG's draft report, was promulgated to address the cost of golden handcuff type plans. These are plans that are created, in connection with a merger or acquisition, to retain company executives. In contrast, TARRP was available to all Medicare employees.

In our view, the primary purpose of TARRP, as implemented for the Medicare Division, was not that of a "golden handcuff" that would render the costs unallowable. Rather, the plan was structured to provide an incentive for employees to support TOLIC and HCFA needs for Medicare claims processing through contract completion and transition activities. This renders the costs allowable pension costs.

c. TOLIC's Annuity Liability Purchase Amount Should Not Be Reduced by \$258,873; the Four TARRP Participants to Whom the Amount Relates Elected to Receive Monthly Annuity Payments

The OIG questions \$258,873 in costs for four Transamerica Retention Retirement Program (TARRP) participants. (OIG Rep. at 9.) In recent correspondence with Mr. Eric Shipley of the OIG's office, we confirmed that the four participants were TARRP participants who chose monthly annuity payments instead of lump sum payments under TARRP. Thus, because they are TARRP participants, the liability is certain and should be allowable as TARRP benefit payments for the reasons set forth above.

TOLIC requests that the OIG amend its draft report to remove the \$4,406,089 increase in pension assets, and to remove the \$258,873 decrease associated with benefits to the four TARRP participants who elected annuity payments.

2. Monthly Annuity and Lump Sum Payments

The OIG asserts that TOLIC inaccurately reduced the segment assets by \$224,376 for monthly annuity and lump sum payments paid after year end. (OIG Rep. at 8.) The OIG "determined that the actual retirement benefits paid to segment participants after the year-end were \$206,239." (OIG Rep. at 8.)

The monthly annuity and lump sum payments paid after year end that were reviewed by the OIG during the audit were based on data available at the time and in some cases were based on estimates. Subsequent to the release of the draft report, the OIG provided TOLIC with the data elements the OIG believed they could not confirm during their audit (Exhibit J.) TOLIC reviewed each of these items and identified support for a total of \$236,230, an increase of \$11,854 from TOLIC's previous estimate, and \$29,991 greater than OIG's amount of \$206,239:

- (1) The following employees received six annuity payments in 2001, not five. We are providing documentation from our payroll system as evidence of these payments. (Exhibit K.):

<u>Name</u>	<u>Annuity Amount</u>
Employee A	\$1,131.66
Employee B	\$2,125.01
Employee C	\$1,230.23

- (2) The following employees are participants offered a lump sum pension distribution. We are providing either the benefit payment election form returned to TOLIC subsequent to the audit, TOLIC's letter to the employee regarding their entitlement to the pension benefit, or documentation of payment. (Exhibit K.):

<u>Name</u>	<u>Election Form or Letter</u>	<u>Annuity Amount</u>
Employee D	Election form	\$7,799.28
Employee E	Letter	\$3,921.77
Employee F	Election form	\$5,560.94
Employee G	Letter	\$1,911.97
Employee H	Record of payment	\$3,700.41
Employee I	Letter	\$2,609.45

Thus, TOLIC requests that the OIG amend its draft report to remove the \$18,137 increase in pension assets, and to decrease the assets by an additional \$11,854 for monthly annuity and lump sum payments paid after year-end.

E. Medicare Net Assets as of January 1, 2001 and Medicare Excess Pension Assets

The OIG "updated the pension assets of TOLIC's Medicare segment from January 1, 1988 to January 1, 2001." (OIG Rep. at 8.) The OIG's "calculation showed that the Medicare segment assets increased by \$5,682,960 to \$50,061,918 as of January 1, 2001." (OIG Rep. at 8.) The OIG's increase of \$5,682,960 represented an aggregate of the adjustments it recommended.

TOLIC maintains that the OIG should not use January 1, 2001 as the valuation date for TOLIC's pension assets. TOLIC believes that, based on equitable considerations arising from the fact that TOLIC could not arrive at an accurate determination of its potential pension fund liability until Fall 2001, and from the dramatic change in the U.S. economy in the year 2001, its

pension segment assets should be valued as of September 30, 2001 instead of January 1, 2001. The value of TOLIC's Medicare segment pension assets experienced a -15.25% change from January 1, 2001 to September 30, 2001.

1. The Use of January 1, 2001 to Determine the Market Value of Medicare Segment Assets Causes an Inequitable Result

The use of January 1, 2001 as the date for determination of the market value of the Medicare segment assets produces a result that is inequitable, *i.e.*, one that is unfair to TOLIC. Such a result would require the company to reimburse the government from its own funds for millions of dollars in pension assets, which, for reasons beyond the control of TOLIC, have evaporated since that date.

a. September 30, 2001 Is The Appropriate Date For Determination Of The Amount Of Any Excess In Pension Assets

September 30, 2001 is the appropriate date to evaluate the value of segment assets, the Medicare segments' final actuarial accrued liability, and any resulting excess because TOLIC's liability was not completely determined until approximately that date. On January 10, 2001, TOLIC partially satisfied the pension liability with a transfer of \$32,121,000 in pension assets to the annuity purchased from Transamerica's Retirement Services. However, additional funds were subsequently required to complete the funding as additional information regarding the final amount of the liability was developed. These additional transfers took place in the amounts of \$824,616 on July 6, 2001 and \$313,843 on November 1, 2001 to fund a total liability of \$33,259,459. Moreover, TOLIC did not become aware that the OIG's recommendation for remittance to the government would amount to some \$20 million for excess pension assets until late September 2001 and, as a result, could not, prior to that date, commence making arrangements to address the recommended payment.

b. January 1, 2001 Is an Inappropriate Date for Valuation of the Medicare Pension Assets Because Economic Conditions Beyond TOLIC's Control Have Caused a Significant Reduction in the Value of Those Assets Since January 1, 2001

A number of factors combined during 2001 to cause serious decline in the financial markets. Those factors are widely known and generally understood as being beyond the control of any person or entity, including TOLIC, and include:

- The onset in March 2001 of the first recession in a decade.
- The September 11, 2001 terrorist attacks.
- An increase in the unemployment rate to 5.8 percent, an overall increase of 45%.
- The number of unemployed persons rose by 2.6 million.
- Consumer confidence fell to an 8-year low.

The performance of the pension fund holding the Medicare segment assets reflected the impact of these factors, as follows:

<u>2001</u>	<u>1Qtr YTD</u>	<u>2Qtr YTD</u>	<u>3Qtr YTD</u>
Total Return	-8.98%	-5.67%	-15.25%

(Exhibit L.)

- c. TOLIC Had Calculated the Excess Pension Assets as of September 30, 2001 to Include a Decrease in the Value of Such Assets of -15.25% or \$1,684,708

TOLIC had calculated the value of pension assets as of January 1, 2001 as \$44,378,957, which, after adjustment for overstatements, understatement, and incorrect reduction of segment assets yields adjusted pension assets of \$44,306,723 as of that date. (See Exhibit A.) After reducing the adjusted pension assets by the purchase price of the annuity liability purchase of \$33,259,459, TOLIC's pension assets are \$11,047,264. (See Exhibit A.)

2. However, as discussed above, TOLIC suffered a 15.25% decrease in its pension assets as of September 30, 2001 so that the value of those assets must be reduced by that percentage or \$1,684,708, resulting in excess pension assets of \$9,362,556. The Cost Accounting Standards Specifically Contemplate Use of an Appropriate Date for Calculation of Value to Achieve an Equitable Result

The Cost Accounting Standards ("CAS") specifically contemplate that the parties may agree on an appropriate date for calculation of market value of assets so as to achieve an equitable result. The CAS provides in this regard:

... (12) If a segment is closed, if there is a pension plan termination, or if there is a curtailment of benefits, the contractor shall determine the difference between the actuarial accrued liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated. The difference between the market value of the assets and the actuarial accrued liability for the segment represents an adjustment of previously-determined pension costs.

(Cost Accounting Standard 413(c)(12) (emphasis added).)

CAS then continues to discuss the date as of which the difference between market value of the subject assets and the actuarial accrued liability shall be calculated:

- (iii) the calculation of the difference between the market value of the assets and the actuarial accrued liability shall be made as of the date of the event (e.g., contract termination, plan amendment, plant closure) that caused the closing of the segment, pension plan

termination, or curtailment of benefits. If such a date is not readily determinable, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date.

(CAS 413(c)(12) (emphasis added).)

The above provision on its face indicates that the drafters of CAS contemplated current market value to be a key consideration in determining the value of the pension assets for which a terminating contractor must reimburse the government.

The Cost Accounting Standards Board has, from its beginning, adhered to the principle that pension fund assets should fairly reflect current market value. Thus, in the preamble to an earlier version of Cost Accounting Standard 413, the Board discussed valuation of pension fund assets in the following terms:⁴

(5) *Valuation of pension fund assets.* A substantial number of commentators objected to the provision of § 413.50(b)(2) of the proposed Standard which required that the value of pension fund assets be within 80 to 120 percent of the market value of such assets. Some commentators stated that such an approach could have a significant impact on pension cost in a year in which there is a large market fluctuation. Many of these seemed particularly concerned that a substantial drop in the market value of fund assets would cause an increase in pension costs.

* * *

The Board notes that there is no opposition to the concept that the actuarial value of pension fund assets should take into account the market value of such assets.

* * *

The Board reiterates its often stated concept that assignment of costs to the proper period is of paramount importance in determining contract costs. Total reliance on valuation methods which fail to produce actuarial values within the specified corridor is not acceptable for contract costing purposes. For the same reasons, the Board does not accept the suggested modifications to the use of a single asset valuation date because these modifications could defeat the objective of assuring that the value of the fund bears an appropriate relationship to current market values.

⁴ The language regarding the parties' agreement "on an appropriate date" if the result of the calculation is inequitable appears in the 1977 version of CAS 413.

(Preamble to Cost Accounting Standard 413, original publication 42 Fed. Reg. 37191, July 20, 1977 (emphasis added).)

The Cost Accounting Standards have from the outset clearly contemplated the use of a date for calculation of market value of pension assets which is reflective of current market value and likely to achieve a result which is fair and equitable. For the reasons discussed above, the appropriate date to be used in the instant case is September 30, 2001.

III. Calculation of Actuarial Accrued Liability and Excess Medicare Assets

A. TOLIC's Annuity Purchase

The OIG asserts that "TOLIC failed to exercise its fiduciary responsibilities to protect government assets by not accepting the lowest legitimate bid for the purchase of the annuity." (OIG Rep. at 8-9.) The OIG asserts that this conclusion was "based on TOLIC's Medicare contract and the FAR." (OIG Rep. at 9.) As a result, the OIG disallows the difference between the lowest bid, adjusted to reflect what the OIG thinks would have been changes in the price between the preliminary bid and a final bid price, and the final purchase amount to TOLIC. (OIG Rep. at 9.) The OIG also reduced the adjusted lowest bid price by \$258,873 for annuity liability payments to four participants incorrectly included. (OIG Rep. at 9.) As mentioned above, we confirmed that this amount actually relates to four TARRP participants who chose monthly annuity payments instead of lump sum payments under TARRP. Therefore, we discuss the allowability of this amount in our discussion of TARRP costs in section II.D.1, above.

1. The OIG Asserts that TOLIC's Purchase of the Annuity from Transamerica Retirement Services Constituted a Purchase From a "Captive Insurer" and Was Therefore "Self Insurance" Whose Cost Could Not Exceed the Cost of "Comparable Purchased Insurance," i.e., Principal's Lower Bid

The OIG presents a somewhat confusing argument regarding its position as to TOLIC's purchase of the annuity liability insurance ("annuity") to implement terminal funding of its Medicare pension liability. As we understand it, the audit report asserts that TOLIC's acceptance of the \$32,864,127 bid of Transamerica Retirement Services to sell TOLIC annuity liability insurance to implement the terminal funding represents a failure "to exercise [TOLIC's] fiduciary responsibilities to protect government assets" in that TOLIC did not accept "the lowest legitimate bid [of \$28,678,987 submitted by Principal Life Insurance Company] for the purchase of the annuity." (OIG Rep at 8-9). The OIG thus determines that TOLIC "should have accepted Principal's bid" and, after making certain adjustments "in consideration of changes made between TOLIC's preliminary bid and the final purchase amount" and in light of TOLIC's incorrect inclusion of "four participants with liabilities in the total amount of \$258,873 in the annuity purchase," concludes that "the Medicare segment's final liability was \$29,834,916." TOLIC's final cost for the annuity liability contract, which the OIG did not have at the time of its audit, was \$33,259,459. (Exhibit M shows the final cost of the annuity liability contract.) Thus, the OIG recommends allowing an amount that is \$3,424,543 less than the amount TOLIC actually paid for the funding.

The OIG bases its conclusion on the Contract Cost Principle entitled "Insurance and Indemnification," which is set out at FAR 31.205-19 and which, pursuant to Appendix B of TOLIC's Medicare Carrier contract, governs the allowability of insurance costs under that contract. The OIG apparently views TOLIC's purchase of the annuity from Transamerica as a form of "self-insurance" and, in light of that view, cites paragraph (b) of the Cost Principle to show that TOLIC "should have accepted Principal's bid":

(b) If purchased insurance is available, the charge for any self-insurance coverage plus insurance administration expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administration expenses.

(FAR 31.205-19(b) (emphasis added).)

The OIG does not explain why it believes that the annuity TOLIC purchased from Transamerica Retirement Services is a form of "self-insurance coverage." Presumably, however, the OIG is relying on paragraph (c) of the Cost Principle, which states in part:

(c) Insurance provided by captive insurers (insurers owned by or under the control of the contractor) is considered self-insurance...

(FAR 31.205-19(c) (emphasis added).)

The OIG's position thus appears to be that (a) Transamerica Retirement Services is a "captive" of TOLIC, therefore, (b) the annuity liability insurance TOLIC purchased from Transamerica Retirement Services is "self-insurance" (c) whose cost "shall not exceed the cost of comparable purchased insurance," the "comparable purchased insurance" in this case being represented by Principal's bid. The OIG's position is incorrect because, if the annuity is considered to be "insurance" at all—which it is not—then it must be considered "purchased insurance" rather than "self insurance." It is further incorrect because the annuity is, in fact not insurance as that term is used in the FAR and because TOLIC conducted the purchase of the annuity in strict accordance with competition requirements and could not have violated its fiduciary responsibilities, as discussed further below.

2. Transamerica Retirement Services Is Not a "Captive Insurer" within the Generally Accepted Meaning of that Term, and Even Assuming the Annuity Is "Insurance," It Is Not "Self Insurance" Within the Terms of the Applicable Cost Principle

Transamerica Retirement Services is a segment of TOLIC whose business purpose is to provide administrative and related services for retiree pension and benefit plans for the general commercial market; thus, by definition it is not a "captive insurer" within the generally accepted meaning of the term. A "captive insurance company" is a corporation organized for the purpose of insuring the liabilities of its owner." *Clougherty Packing Co. v. Commissioner of Internal Revenue*, 811 F2d 1297, 1298 n.1 (9th Cir. 1987). The business configuration of a "captive insurer" can take a variety of forms. "At one extreme is the case...where the insured is both the sole shareholder and only customer of the captive" *Id.* Other cases may involve "less than 100%

ownership or more than a single customer, although at some point the term "captive" is no longer appropriate." *Id.* Because Transamerica Retirement Services sells its pension and benefits administration services on the commercial market and its provision of such services to TOLIC is substantially less than half of its business, the term "captive" is not an "appropriate" description of the entity.⁵ In fact, a complete reading of paragraph (b) of the Cost Principle on which the OIG relies reveals that the annuity is not to be considered self-insurance but, rather, where the annuity was competitively procured—as it was in this instance—it is to be considered purchased insurance:

(c) Insurance provided by captive insurers (insurers owned by or under the control of the contractor)...is considered self-insurance...However, if the captive insurer also sells insurance to the general public in substantial quantities, and it can be demonstrated that the charge to the contractor is based on competitive market forces, the insurance will be considered purchased insurance.

(FAR 31.205-19(c) (emphasis added).)

3. FAR 31.205-19, Insurance and Indemnification, Is Inapplicable to the Annuity Purchased by TOLIC Because the Annuity Is Not "Insurance" as that Term Is Defined by the FAR

The auditor's citation of the cost principle set out at FAR 31.205-19 as the basis for disallowance of the cost of the purchase of the annuity from Transamerica Retirement Services and the substitution of the cost of the Principal bid is inapposite because the annuity is not insurance as that term is defined and used in the FAR:

"Insurance," as used in this part, means a contract which provides that for a stipulated consideration, one party undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event.

(FAR 28.001, Definitions.); see also CAS 416-30(a)(4). The annuity in question here is clearly not within the FAR definition of "insurance" as indemnification against a "liability arising from an unknown or contingent event." The "event" in question here was neither "unknown" nor "contingent" within any reasonable meaning of either of those terms. Rather, the "event" is one of which both TOLIC and the government have long been aware and was, in fact, so well known that the relevant liability has already been specifically and painstakingly quantified. And it is not contingent for the same reason, *i.e.*, both TOLIC and the government are specifically aware that the "event" will happen. The occurrence of the "event" is so certain that the resulting liability can be specifically quantified. TOLIC did not purchase the annuity as an indemnification against "loss, damage, or liability arising from an unknown or contingent event" The annuity is,

⁵ Transamerica Retirement Services has been active in the terminal funding annuity liability commercial market for over 20 years, and has terminal funding annuity liabilities totaling approximately [REDACTED] as of year end 2001. The Medicare segment terminal funding annuity purchase represents less than [REDACTED] of Transamerica Retirement Services' total inforce terminal funding annuity liability business.

therefore, clearly not "insurance" as the FAR defines that term and is not governed by the provisions of FAR 31.205-19.

4. The Annuity Purchased by TOLIC Is a Cost of Pension Benefits and Administration

Payments made to assure proper administration of a pension plan are costs incurred to assure that promised benefits or contributions are in fact provided to beneficiaries. Such payments have nothing to do with protecting the contractor against risk of loss to which it is exposed. Thus, the FAR defines a pension plan as "a deferred compensation plan established and maintained by one or more employers to provide systematically for the payment of benefits to plan participants after their retirements, provided that the benefits are paid for life or are payable for life at the option of the employees." FAR 31.001. Transamerica's pension fund contract costs fall squarely within this definition. The contract is for the purchase of non-participating, guaranteed, fixed annuities for certain qualified retirement plan participants.

Even where pension liabilities are settled through the purchase of annuity contracts from an insurance company, the underlying cost is not charged to insurance but remains a pension cost. Thus, the annuity purchase price is a cost incurred to assure payment of promised benefits rather than to protect against risk of loss.

The application of FAR cost principles in *Ralph M. Parsons Company*, ASBCA Nos. 37931, 37946, and 37947, 91-1 BCA ¶ 23,648 (1990), demonstrates that a plan which pays benefits for life meets the definition of a pension plan. The case involved the company's Employee Stock Ownership Plan ("ESOP") costs. Defense Acquisition Regulation ("DAR") 15.205-6(j)(7) Pension Costs contained criteria regarding the allowability of pension costs, while DAR 15.205-6(k) contained no specific mention of ESOP costs. The ASBCA found that the ESOP plan did not pay benefits for life and therefore did not meet the definition of a pension plan:

We also agree with the parties' present position that appellant's 1984 ESOP contribution costs do not fall within DAR 15.205-6(j). This cost principle pertains to certain costs of employee stock ownership plans. While both parties long took the position that appellant's ESOP costs were subject to DAR 15.205-6(j)(7) ... that cost principle does not control because it looks to plan costs that constitute a form of pension costs. In turn, under DAR 15.205-6(j), pension costs are confined to those for plans providing benefits that are either "paid for life or ... payable for life at the option of the employee." In 1984, appellant's plan did not meet these lifetime requirements.

Under the analysis of the Board in *Ralph M. Parsons Company*, the cost principle that applies to the allowability of pension costs is the one that applies to costs for a plan that provides benefits that are paid for life or payable for life at the option of the employee. In the present case, that cost principle is FAR 31.205-6(j), not FAR 31.205-19. Accordingly, the costs associated with the terminal funding contract are allowable in their entirety.

5. TOLIC Fulfilled Its Fiduciary Responsibilities in that the Contract Was Properly Awarded as a Result of a Competition in which Price Competition Involving Market Forces Existed

In August 2000, TOLIC sought competitive bids for annuity liability insurance to address the terminal funding contract requirements.⁶ In so doing, TOLIC prepared bid packages that it provided to contractors as a basis upon which to prepare their bids. Because the TOLIC pension plan is extremely complex and is based upon complicated assumptions, TOLIC went to great lengths to include information in the bid packages that would permit entities to understand the complexities of the pension plan and, thus, to submit reasonable and realistic pricing for the work to be performed. TOLIC received initial bids from three entities – Hartford, AIG, and Principal.

Despite the scope and breadth of the information contained in the bid packages, it was TOLIC's opinion based on the initial offers received, that both Hartford and Principal [REDACTED] the early retirement provisions in the Transamerica pension plan. As a result, both entities submitted bids that, in TOLIC's opinion, contained [REDACTED] Hartford and Principal also [REDACTED] the loading factors, as did AIG, which, in TOLIC's judgment, also impacted the [REDACTED] of their bid prices.

After engaging in discussions with the bidders about their [REDACTED] regarding loading factors and the early retirement provisions in the pension plan,⁷ TOLIC requested a second round of bids in November 2000.⁸ This process of initial and final bids is typical of a terminal funding bidding process.⁹ Bids are revised as a result of changes to or clarification of the pension plan, as occurred here. Revisions to final bids are unlimited in scope and nature, and, in many instances, can have a significant impact on the bid price as well as the legitimacy of

⁶ On September 15, 2000, Richard Weinstein of TOLIC called Eric Shipley of HCFA for the express purpose of confirming TOLIC's course of action in proceeding with the competitive award of a terminal funding contract. Mr. Shipley stated that HCFA would not challenge the price of a competitively awarded contract. He stated further that HCFA preferred either a terminal funding purchase or an immunization approach as opposed to TOLIC taking no action. Mr. Shipley advised Mr. Weinstein that TOLIC could terminal fund its Medicare liability because TOLIC is already in this line of business. Naturally, Transamerica's price would have to be competitive with the other bids, as demonstrated by a comparison of bids. Mr. Shipley asserted that TOLIC need not make award on the basis of the lowest bid, as long as the awarded price was competitive. TOLIC relied on the guidance provided by Mr. Shipley in its analysis of bids and in its award decision.

⁷ Bidders submitted questions both orally and in writing to both TOLIC and to Brentwood Asset Advisors, the independent consultant retained by TOLIC to assist in the bid process.

⁸ The proposal that accompanied the quotes submitted to TOLIC outlined the plan provisions, participant data, and assumptions used to price the premium. By analyzing the proposals submitted by AIG, Hartford, and Principal, TOLIC was able to determine that the bidders had [REDACTED] the early retirement assumptions and loading factors. TOLIC was also able to analyze relevant data submitted with final bids to ascertain that, in TOLIC's opinion, Principal's final bid price continued to be [REDACTED]

⁹ The competitive bidding process employed by TOLIC for the terminal funding contract, e.g., requesting initial bids, analyzing the price quotes, and, after discussions with bidders, requesting final bids, is similar to the requirements for competitive acquisition set forth in Part 15 of the Federal Acquisition Regulation.

the entire bid submission. For example, such price changes in final bids can impact asset rates, which would in turn result in changes to a bidder's liability pricing rate and the spread used to cover indirect costs.

In response to its request for final offers, TOLIC received quotes from Hartford, AIG, and Principal, as well as a quote from Transamerica Retirement Services to perform the terminal funding work. As is permitted in the bidding process and as prompted by the additional information provided to the bidders by TOLIC during the two rounds of bidding, AIG and Hartford re-priced their bids based upon their clarified understanding of the early retirement provisions in the Transamerica pension plan and the relevant loading factors. As a result, both the AIG and Hartford bid prices [REDACTED] their final bid prices were consistent with that quoted by Transamerica (\$31,342,000) and, thus, were necessarily realistic and reasonable as they reflected the complicated provisions of the pension plan.¹⁰

In contrast, the Principal quote of \$28,678,987 remained [REDACTED] and, in TOLIC's judgment, continued to reflect [REDACTED] of the loading factors and assumptions embedded in the Transamerica pension plan. These elements continued to be [REDACTED] and, thus, [REDACTED]. For example, the Transamerica quote was based upon an asset rate of [REDACTED] and a liability pricing rate of [REDACTED]. The Principal quote could have been based upon a liability pricing rate of no more than [REDACTED]¹¹ which translates into a rate of [REDACTED] per basis point and a spread of [REDACTED] (as opposed to the spread of [REDACTED] in Transamerica's quote). In Transamerica's judgement, as a result of [REDACTED] per point basis rate and a spread of [REDACTED] Principal would have been [REDACTED]

TOLIC did not simply rely on its own internal analysis of the bids to determine that the AIG and Hartford bids were reasonable, realistic, and competitive, and that Principal's bid price was [REDACTED]. TOLIC also engaged Brentwood Asset Advisors ("Brentwood") to complete an independent and objective analysis to determine the appropriateness of the consideration of the bid from Transamerica and, in so doing, to evaluate the bids submitted by the four prospective contractors, including Transamerica. In a report provided to TOLIC on December 4, 2000, Brentwood concluded that the price bid by Principal was [REDACTED]

¹⁰ Because AIG and Hartford only included [REDACTED] in their bids instead of the special death benefits required by the TOLIC pension plan, their bids were adjusted for price evaluation purposes to more than [REDACTED]. It was in TOLIC's opinion that a properly priced bid from Principal would have fallen in the same range.

¹¹ As a point of comparison, the Moodys Corporate A Index was 8.22% on November 27, 2000, and the 30-year Treasury bond was 5.79% on that date.

¹² We believe the OIG has the Brentwood Asset Advisors Report in its possession.

All analyses pointed to the same conclusion, namely that Principal's bid price was [REDACTED]. In TOLIC's judgment, it was [REDACTED]. Principal's price was [REDACTED].

[REDACTED] Thus, by declining to accept Principal's [REDACTED] bid price after a rational, purposeful, and predictable bidding process, TOLIC was exercising its fiduciary duty to HCFA and was protecting the public fisc from inappropriate and unsound expenditure.

After the significant analysis and evaluation described above, TOLIC competitively awarded the terminal funding contract to Transamerica Retirement Services in a manner consistent with its contractual obligations to HCFA. Unlike the bid price submitted by Principal, the bid submitted by Transamerica Retirement Services was reasonable and realistic, and TOLIC "would not pay more than adequate consideration" by making award on the basis of this bid. (Brentwood Asset Advisors Report dated December 4, 2000 at 2.) Moreover, the overall stability of the carrier, as well as Transamerica Retirement Services' familiarity with the complexities of the pension plan justified the contract award. *Id.* at 4. Transamerica Retirement Services "qualif[ied] as a 'safest available' carrier." *Id.*

6. The Costs Associated with the Terminal Funding Contract Are Reasonable and, Therefore, Allowable

The Cost Principles in Part 31 of the FAR require that the costs must be allowed if they are reasonable. FAR 31.201-3(a) states that "a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." Specifically in regard to insurance costs, FAR 31.205-19(a)(i) similarly states that the "[c]osts of insurance maintained by the contractor in connection with the general conduct of its business are allowable" so long as the "[t]ypes and extent of coverage ... follow sound business practice, and the rates and premiums [are] reasonable." If these requirements are not met, then the costs are unallowable.

In addition, specifically in regard to the costs of insurance provided by captive insurers, the FAR states that the cost must be based on "competitive market forces":

(c) Insurance provided by captive insurers (insurers owned by or under the control of the contractor) is considered self-insurance, and charges for it must comply with the self-insurance provisions of 48 CFR 9904.416. However, if the captive insurer also sells insurance to the general public in substantial quantities and it can be demonstrated that the charge to the contractor is based on competitive market forces, the insurance will be considered purchased insurance.

(FAR 31.205-19(c).) Although we believe that TOLIC is not a "captive insurer," as defined above, we will assume for purposes of this analysis that it is, and apply the standard required by this regulation.

Under the standard in FAR 31.201-3(a)—that TOLIC act as a prudent person in the conduct of competitive business—the costs of TOLIC's contract are reasonable and therefore allowable. The costs were incurred as a result of a competition in which TOLIC received three similarly priced offers from large insurance companies. The fact that the offers from the three large insurance companies were similarly priced indicates that they represent market prices for the services being procured. From those three offers, TOLIC chose the bidder that had the most experience and familiarity with the services being procured. TOLIC acted the way any prudent business would in contracting for a service—it considered price, experience and familiarity with the services to be provided in making its decision. There is no indication that its decision was in any way arbitrary or unreasonable. Therefore, the costs incurred do not exceed that which would be incurred by a prudent person in the conduct of competitive business, as required by FAR 31.201-3(a), and are therefore reasonable and allowable.

TOLIC also meets the reasonableness requirement of FAR 31.205-19(a)(i). The fact that the offers from the three large insurance companies were very close to each other in price indicates that the price of the selected contract is a market price and, therefore, is reasonable.

Even assuming that FAR 31.205-19(c), the regulation applicable to captive insurers generally, is applicable here, it is clear that the costs in question are allowable. The fact that a competition was conducted, three offers were received, and similarly priced offers were submitted by three large insurance companies constitutes evidence that the costs are the result of "competitive market forces," as required by FAR 31.205-19(c).

Finally, there is no requirement in the contract that TOLIC select the lowest priced offer for services of this type or for the costs associated with the contract to be considered reasonable for purposes of allowability. TOLIC, therefore, had discretion to select the awardee by exercising reasonable business judgment. When a contractor has discretion to incur costs, the costs incurred cannot be disallowed on the grounds of unreasonableness unless the contractor acted arbitrarily in the exercise of its business judgment. See John Cibinic, Jr. & Ralph C. Nash, Jr., *Cost Reimbursement Contracting* 730-733 (2d ed. 1993); *Wyman-Gordon Co.*, ASBCA, 59-2 BCA ¶ 2344; *Western Elec. Co.*, ASBCA 11056, 69-1 BCA ¶ 7660. Costs incurred cannot be disallowed even if the method chosen by the contractor is more costly than other available methods, so long as the contractor's exercise of business judgment is reasonable and not arbitrary. *Marquardt Aircraft Co.*, ASBCA 1587, 57-2 BCA ¶ 1467; *Vare Indus., Inc.*, ASBCA 12126, 68-2 BCA ¶ 7120. TOLIC did not act arbitrarily in exercising its business judgment and awarding the contract to Transamerica Retirement Services. Its decision was based on a procurement that involved price competition and a reasonable evaluation of the bidders' experience and familiarity with the services to be provided. Thus, its costs cannot be disallowed on the grounds of abuse of discretion.

In conclusion, the cost of TOLIC's annuity liability contract with Transamerica Retirement Services, \$33,259,459, is reasonable and was incurred in Transamerica's non-arbitrary exercise of business judgment and is, therefore, allowable. TOLIC requests that the OIG amend its draft report to decrease the pension assets by \$33,259,459, rather than by \$29,834,916.

B. Excess Medicare Pension Assets

The OIG determined the excess Medicare pension assets by "reduc[ing] the January 1, 2001 Medicare segment assets of \$50,061,918 by the allowable Medicare segment final liability of \$29,834,916." (OIG Rep. at 9.) The OIG concluded that "[t]he difference of \$20,227,002 represents excess Medicare pension assets that must be remitted to the Federal government." (OIG Rep. at 9.)

TOLIC maintains that its adjusted pension assets are \$44,306,723, that those assets should be reduced by \$33,259,459 (which represents the entire final purchase price of the annuity liability contract) and that the difference should be reduced by the 15.25% decrease in pension asset value from January 1, 2001 to September 30, 2001. This results in \$9,362,556 in excess pension assets TOLIC must remit to the government.

IV. Conclusion

For the foregoing reasons, TOLIC requests that the OIG revise its draft report to recommend that TOLIC remit \$9,362,556 to the federal government.

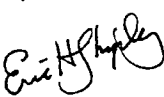
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MEMORANDUM

To: Greg Tambke, Audit Manager
HHS/OIG/OAS, Jefferson City, Missouri

From: Eric Shipley 

Date: March 8, 2002

Subject: Response to the Draft OIG Audit Report CIN A-07-01-00125, *Audit of the Pension Plan at a Terminated Medicare Contractor, Transamerica Occidental Life Insurance Company.*

In a letter dated February 14, 2002, Transamerica Occidental Life Insurance Company (TOLIC), responding through W. Bruce Shirk of Powell, Goldstein, Frazer and Murphy, LLP, objected to certain findings and methodology used in the above cited draft OIG audit report. This audit report addresses the asset roll-up from January 1, 1988 to January 1, 2000 and the segment closing adjustment required under paragraph 413-50(c)(12) of the Cost Accounting Standards (CAS). TOLIC contends that –

1. Investment earnings and expenses recognized in the asset roll-up were improperly allocated to the Medicare segment;
2. Payments and annuities provided under the Transamerica Retention and Retirement Program (TARRP) should be recognized as an allowable cost;
3. The segment closing adjustment should be measured as of September 30, 2001; and,
4. The full amount of the premium paid to TOLIC for the purchase of the annuity contract should have been recognized in the measurement of the segment closing adjustment.

TOLIC also asserts that additional benefit payments should be recognized in the asset roll-up and has provided documentation that was not available prior to the issuance of the draft audit report. The sufficiency of this new benefit payment documentation is not an actuarial or pension accounting issue and is not addressed herein. The benefit payment documentation will be reviewed by the auditors in accordance with their established standards and procedures and will be addressed separately. Although TOLIC also notes that the OIG assignment of

contributions to the Medicare segment had the effect of "reducing the January 1, 2001 pension value," the company does not object apparently because such a reduction works in its favor.

Discussion

1. Investment earnings and expenses recognized in the asset roll-up were improperly allocated to the Medicare segment.

TOLIC Comment: TOLIC acknowledges that its established actuarial cost method, i.e., cost accounting practice, was to use the average value of assets as the base for allocating total company investment earnings to the Medicare segment for pension plan years 1986 and 1987. TOLIC asserts that because the provisions of CAS 413 were incorporated by direct reference into its FY 1988 Medicare contract through Item XVI, *Pension Costs*, of Appendix B, TOLIC was obligated to make a mandatory accounting practice change and use the value of assets at the beginning of the year as the base for allocating investment earnings to the segment starting with the 1988 pension plan year. TOLIC then takes the position that because it has not negotiated new contract terms with the Centers for Medicare & Medicaid Services (CMS)¹ since 1988, it is not subject to the March 30, 1995 amendments to CAS 412 and 413. TOLIC concludes that it was required to use the beginning value of assets as the base for allocating investment earnings for 1988 and all subsequent pension plan years.

Response: TOLIC became subject to the original CAS 412 and 413² starting with its Medicare contract for the Medicare Fiscal Year ending October 1, 1981 (FY81), which was executed after CAS 412 and 413 were incorporated into the Section 15.205-6(f)(3) of Federal Procurement Regulation on February 19, 1980.³ (FPR 15.205-6(f)(3) was subsequently replaced by Section 31.205-6(j) of the Federal Acquisition Regulations (FAR).) The clause found at Item XVI, *Pension Costs*, of Appendix B was added to the FY88 Medicare contract as the result of negotiations between CMS and its contractors. This clause clarified (i) how a Medicare segment was to be identified, (ii) the basis for initially allocating assets to the segment, and (iii) when separate calculations of pension cost for the segment would be required. While paragraph CAS 413-50(c)(7) was cited as the basis for updating assets after the initial allocation had been made, the specifics of that paragraph were not the subject of the Appendix B, Item XVI. In fact, the preamble to the clause states that "[t]he Secretary and the contractor reserve their rights with respect to pension issued not addressed in this Item XVI." TOLIC has been subject to the provisions of CAS 413-50(c)(7), as originally promulgated, from 1981 until CAS 413 was amended on March 30, 1995.

It was after TOLIC's FY88 contract was negotiated and executed that OIG auditors reviewed TOLIC's compliance with the pension clause. On August 19, 1991, their findings and recommendations were issued in an audit report, CIN A-07-91-00391, titled, *Medicare*

¹ CMS was formerly named the Health Care Financing Administration (HCFA).

² References to the original CAS 412 and 413 mean CAS 412 as published on September 24, 1975 (40 FR 43873) and CAS 413 as published on July 20, 1977 (42 FR 37191).

³ Section 1100, Introduction, of Appendix B (10-80) incorporated the provisions of FPR 1-15.2 into the newly negotiated Medicare contracts.

Contractor's Segmented Pension Cost – Transamerica Occidental Life Insurance Company, Los Angeles, California. In the details of the audited asset update shown in Appendix A of the report, the OIG auditors noted that TOLIC used the average value of assets as its allocation base. The auditors, who were auditing against the provisions of the original CAS 413 and Item XVI of Appendix B of the Medicare contract, did not take exception to allocations based on the average value of assets, as this method of allocation was TOLIC's established cost accounting practice. When determining the audited value of assets of January 1, 1988, the auditors, with advice from the CMS actuaries, adhered to TOLIC's established practice because it followed general actuarial practice and produced more accurate results when contributions and/or benefit payments were disproportionately attributable to a particular segment. Because the method used by TOLIC was more stringent and accurate than the method described in CAS 413-50(c)(7), the auditors believed they had no basis to find a noncompliance. By neither disavowing nor objecting to its use, TOLIC affirmed and ratified that this method was the company's established practice for determining pension costs under its FY88 contract.

According to internal memos dated December 26, 1989 and December 6, 1990 from Richard Weinstein to Flora Bahaudin, TOLIC used the average assets method to update the Medicare segment assets for pension plan years 1989 and 1990, respectively. After issuance of the OIG audit report, TOLIC changed its cost accounting practice and used the beginning of year asset value to allocate total earnings to the segment in the update assets for the 1991 segment valuation, according to another memo from Richard Weinstein to Flora Bahaudin dated February 11, 1992. In that same valuation memo, TOLIC restated the asset updates for 1989 and 1990 using the beginning of year value of assets to allocate earnings. Thus, contrary to Appendix B, Item II, Paragraph A⁴ of the Medicare contract, TOLIC changed its established and accepted cost accounting practice⁵ without notice to and approval of the CMS Contracting Officer. Therefore, the OIG auditors properly continued use of TOLIC's established and accepted practice for allocating total company investment earnings to the Medicare segment.

When CAS 413 was amended on March 30, 1995, CAS 413-50(c)(7) was revised so that investment earnings were to be allocated to segments using the average value of assets. The prefatory remarks published with the amendments noted that many technical changes were being made to improve consistency between CAS 412 and 413 and standard actuarial practices.⁶ Paragraph CAS 413-63(b) of the amended Standard provided that the revised Standard "shall be

⁴ Paragraph A of Appendix B, Item II, *Accounting Practices*, reads:

A. Consistency in estimating, accumulating and reporting costs. Each contractor's practices used in estimating costs for proposal purposes shall be consistent with cost accounting practices used by him in accumulating and reporting costs. Consistency in the application of cost accounting practices is necessary to enhance the likelihood that comparable transactions are treated alike. However, the grouping of homogeneous costs in estimates prepared for proposal purposes shall not, in and of itself, be deemed an inconsistent application of cost accounting practice under the above when such costs are accumulated and reported in greater detail on an actual cost basis during contract performance.

⁵ TOLIC was not required to submit a CAS Disclosure Statement (DS-1) or similar declaration. Therefore, the information provided in the OIG audit report CIN A-07-91-00391, including TOLIC's response, provides the best evidence of the company's established cost accounting practice. By sustaining the findings of the audit report, CMS evidenced knowledge of the report's contents and accepted TOLIC's cost accounting practice.

⁶ See 60 FR 16535, last full paragraph of the third column.

followed by each contractor on or after the start of its next cost accounting period after the receipt of a contract or subcontract to which this Standard is applicable.” Thus, any contractor who became subject to FAR 31.205-6(j)⁷ on or after March 30, 1995 became subject to the amended CAS 413. Item I, Paragraph A of Appendix B to the FY88 Medicare contract states that the contractor is to be subject to Part 31 of the FAR “as it may be modified on or before each June 15 thereafter for any renewal period.” TOLIC’s assertion that it is not subject to the amended CAS 412 and 413 is without merit. Clearly, TOLIC was required to continue its established practice, using the average value of assets as its allocation base for investment earnings.

2. Payments and annuities provided under the Transamerica Retention and Retirement Program should be recognized as allowable pension cost.

TOLIC Comment: TOLIC believes that the cost of the TARRP should be recognized as an allowable pension cost and deducted from the Medicare segment’s assets when measuring the segment closing adjustment amount. TOLIC disagrees with the audit finding that the cost of the TARRP is unallowable under FAR 31.205-6(l), *Compensation Incidental to Business Acquisitions*. TOLIC further asserts that CMS intended that the TARRP be used to ensure continued service and a smooth transition.

Response: Prior to the acquisition of TOLIC by AEGON, TOLIC employees were covered by the Separation Pay Plan. When AEGON purchased TOLIC in 1999, Supplement A, “Transamerica Retention and Retirement Program (TARRP),” was added to the Retirement Plan for Salaried U.S. Employees of Transamerica Corporation and Affiliates (TOLIC pension plan) by amendment originally executed July 22, 1999 and was effective July 21, 1999. The Introduction section of the Summary Information booklet⁸ explains the purpose of the TARRP as follows:

The Transamerica Retention and Retirement Program (“TARRP”) has been established by the Company to provide special benefits to eligible Transamerica employees to encourage them to remain with the Company and be productive in the positions while the integration strategy with AEGON is being implemented. The TARRP will provide enhanced separation benefits for those eligible employees whose employment is terminated for Qualifying reasons, as defined in this Summary, by a Participating Company within a three-year period after the merger with AEGON (the “TARRP Window Period” from July 21, 1999 through July 20, 2002. [Emphasis added.]

AEGON was concerned that employees might seek other employment in reaction to the anxieties and concerns that accompany a change of ownership, and the TARRP was an enhanced severance pay plan designed to retain employees during a tight labor market. The TARRP added to the cost of doing business over and above that of TOLIC’s existing severance pay policy, and

⁷ FAR 31.205-6(j) incorporates CAS 412 and 413 by direct reference.

⁸ This text is quoted from a December 9, 1999 copy of the Summary Information.

this extra cost is due to AEGON's efforts to maintain the value and operations of its new acquisition.

To be eligible for a TARRP benefit, an employee generally had to (i) be an active, regular salaried employee on a U.S. payroll, (ii) be employed by one of the named participating companies, (iii) have an established termination date between July 21, 1999 and July 20, 2002, and (iv) be terminated because of a reorganization, reduction in force, or sale of assets. Participation in the TARRP was not conditioned upon eligibility for a non-TARRP pension benefit. Employees who accepted a TARRP benefit were not eligible for benefits under TOLIC's Separation Pay Plan.

Much confusion has been created by the misleading name of this severance pay plan. The TARRP replaced the existing Separation Pay Plan and provided more generous benefits. Unlike the payment under the Medicare Transition Retention Bonus Plan, which is paid to employees who remain with the company until their position is eliminated, regardless of whether they accept employment with the replacement contractor, the TARRP payment is not a retention bonus. Under the terms of both the Separation Pay Plan and the TARRP, employees were eligible only if their employment was discontinued, i.e., severed, because either other TOLIC units or the replacement contractor employed them.

After TOLIC decided not to renew its Medicare contract in February of 2000, CMS did approve and fund the Medicare Transition Retention Bonus Plan. Meanwhile, CMS consistently discussed the TARRP in terms of a severance pay plan. The only substantive issue concerned whether the drug test requirement proposed by the replacement contractor affected the employees' freedom to apply for follow-on employment. But this issue was resolved when the drug test requirement was removed.

Previously, on May 21, 1999, all Medicare contractors were notified of CMS's policy concerning the reimbursement of severance pay related to the termination or nonrenewal of the contract. The notice set forth general conditions under which CMS would reimburse severance pay. These conditions included the following:

- 1) The reimbursement of the severance pay must be allowable under FAR 31-205-6 and based on authority found at FAR 31.201-4(b) and FAR 31.205-6(a), (b), and (g);
- 2) The contractor must have an established, written severance policy in place;
- 3) CMS must find the severance pay policy to be reasonable;
- 4) Severance pay must not be paid to employees hired by the replacement contractor; and
- 5) Severance pay must not be paid to employees hired by the outgoing contractor's private lines of business, or by any of its affiliates.

The TARRP did satisfy conditions (2), (4), and (5) concerning a severance pay plan,⁹ but it fails condition (1) because the cost is unallowable under FAR 31.205-6(l). CMS staff was concerned about the increase in the severance pay under the TARRP, but condition (3) was neither addressed nor negotiated because TOLIC never presented a Supplemental Budget Request or other approval.

The TARRP payments exceeded, by about \$4.2 million, the amount was properly paid in accordance with the terms of the TARRP and CMS's severance pay guidance. During the audit, Steve Fenic of TOLIC provided a listing of the TARRP lump sum values that were paid or payable, including those for which an annuity was elected. The listed TARRP payments made to 221 employees totaled about \$4.7 million. However, a comparison of this list with a listing of employees who were offered or eligible for employment by the replacement contractor indicates that only 28 employees were actually eligible for TARRP benefits totaling about \$414,000 to \$566,000.¹⁰ Therefore the severance pay cost under the TARRP that CMS might have agreed to reimburse could not have been greater than \$566,000, if this cost were allowable.

The TARRP came into being because of AEGON's acquisition of TOLIC prior to the company's decision not to renew the Medicare contract. An analysis by CMS staff finds that the TARRP provides benefits that are 13.5 to 61.5 percent greater than the Separation Pay Plan. There is no evidence that TOLIC would have enhanced the benefit of its Separation Pay Plan, were it not for its purchase by AEGON. Even if CMS had agreed to reimburse the cost of the TARRP for eligible employees, the cost of the enhanced benefits under the TARRP is unallowable under FAR 31.205-6(l). While the prefatory comments to the publication of FAR 31.205-6(l) refer to "golden handcuffs" and "golden parachutes" for executives, these proposed definitions were deleted from the Final Rule. Instead, the Final Rule is written in the general terms of "payments to employees." The TARRP is unallowable because it provides excess severance pay following a change in management control and ownership and falls within the language of paragraph FAR 31.205-6(l)(1). Even if the TARRP were not a severance pay plan, it would be unallowable under paragraph FAR 31.205-6(l)(2) because the TARRP provides special compensation that is contingent upon employees remaining with TOLIC for a specified period of time after the actual change in management control or ownership.

Because the TARRP refers to "retirement" and was funded by an amendment to the TOLIC pension plan, confusion again arises as to what type of benefit is being provided. However, the basic TARRP payment is not a retirement income benefit,¹¹ but a lump sum amount based solely upon an employee's years of service and weekly salary, regardless of his/her date of hire or age. Eligibility for the TARRP payment is not related to eligibility for either plan participation¹² or the regular retirement income benefit¹³ under the TOLIC pension

⁹ See the letter dated September 18, 2000 from the CMS Contracting Officer, John Barton.

¹⁰ Diane Teakle of the CMS Regional Office and NHIC reviewed this listing.

¹¹ An employee can elect to have the lump sum amount converted into either a deferred or immediate annuity, which includes a spousal death benefit.

¹² Age 21 and one year of completed service.

¹³ That is, a retirement income benefit payable to plan participants who have meet the requirements to normal retirement, early retirement, disability, or vesting.

plan. Because the TARRP benefit is severance pay, it is not a pension or ancillary benefit as that term is used in FAR Part 31.¹⁴ Because the FAR definition of ancillary benefits includes common examples but might not be considered exhaustive, rules related to the Employees Retirement Income Security Act of 1974 (ERISA) can be used for outside authoritative guidance. It is my professional opinion that the benefit fails the ERISA requirements found in Internal Revenue Service Regulation 1.401-1(b)(1)(i) and does not qualify as an ancillary pension benefit. Furthermore, I believe that the TARRP payment is not a retirement income benefit and therefore cannot be deemed a "shutdown" pension under General Counsel Memorandum 39869, issued 04/06/92, even though a spousal death benefit is provided if payment as a deferred or immediate annuity is elected.

If, for argument's sake, the TARRP could be found to be an allowable pension benefit as TOLIC contends, only about \$151,000 (26.67 percent of \$566,000) of TARRP costs could be included in the measurement of segment closing adjustment. Subdivision CAS 413-50(c)(12)(iv) requires that if a pension plan amendment is adopted within 60 months of the segment closing date, the liability amount associated with that amendment must be phased in on a pro-rata basis.¹⁵ Therefore, the allowable cost must be multiplied by a fraction, consisting of a numerator of 16 months¹⁶ divided by 60 months.

3. The segment closing adjustment should be measured as of September 30, 2001.

TOLIC Comment: TOLIC believes that the segment closing adjustment should be measured as of September 30, 2001. The company asserts that measuring the segment closing adjustment as of January 1, 2001 produces an inequitable result. As justification, TOLIC cites CAS 413-50(c)(12)¹⁷ and CAS 413-50(c)(12)(v). TOLIC also refers to comments by the Cost Accounting Standards Board (CASB) found in Section (5) of Preamble A to CAS 413 as originally published on June 2, 1976.

¹⁴ See FAR 31.001, "Definitions" which reads as follows:

Pension plan" means a deferred compensation plan established and maintained by one or more employers to provide systematically for the payment of benefits to plan participants after their retirements, provided that the benefits are paid for life or are payable for life at the option of the employees. Additional benefits such as permanent and total disability and death payments, and survivorship payments to beneficiaries of deceased employees, may be an integral part of a pension plan. [Emphasis added.]

¹⁵ CAS 413-50(c)(12)(iv) states: "Pension plan improvements adopted within 60 months of the date of the event which increase the actuarial accrued liability shall be recognized on a prorata basis using the number of months the date of adoption preceded the event date. Plan improvements mandated by law or collective bargaining agreement are not subject to this phase-in."

¹⁶ 16 months is the number of months from July 22, 1999, which is the date the TARRP amendment was adopted, to November 30, 2000, which is date the contract ended and the segment closed.

¹⁷ CAS 413-50(c)(12) states:

If a segment is closed, if there is a pension plan termination, or if there is a curtailment of benefits, the contractor shall determine the difference between the actuarial accrued liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated. The difference between the market value of the assets and the actuarial accrued liability for the segment represents an adjustment of previously-determined pension costs.

Response: CAS 413-50(c)(12)(iii) of the amended CAS 413, which is substantially the same as that portion of the original segment closing provision,¹⁸ states:

The calculation of the difference between the market value of the assets and the actuarial accrued liability shall be made as of the date of the event (e.g., contract termination, plan amendment, plant closure) that caused the closing of the segment, pension plan termination, or curtailment of benefits. If such a date is not readily determinable, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date.

TOLIC, CMS, and the OIG have agreed that that the Medicare contract ended on November 30, 2000. Medicare employees were required to work until November 30, 2000 to be eligible for the TARRP severance bonus, unless their positions were eliminated sooner. Thus, the date of the event that caused the segment closing, i.e., the date the Medicare contract ended, is readily determinable.

The next normal actuarial valuation of the TOLIC pension plan was to be measured based on reports and data as of January 1, 2001. Because requiring an actuarial valuation 32 days earlier, as of November 30, 2000, would have burdened TOLIC with additional expense and effort, the auditors offered TOLIC the choice of either November 30, 2000 or January 1, 2001 as the date for measuring the segment closing adjustment. Both parties then agreed upon January 1, 2001 as the appropriate date to measure the cost effect of the segment closing event. These are exactly the considerations and agreement intended by both the original and current CASB.

Because some of the transactions, such as premium and lump sum settlement payments, occurred on dates other than January 1, 2001, the auditors, with agreement from TOLIC and its actuaries, adjusted those transactions to a current value as of January 1, 2001 based on the long-term interest rate assumed for the actuarial valuation. Use of the long-term interest rate assumption complies with CAS 413-50(c)(12)(i)¹⁹ and is appropriate because it recognizes that investment returns can widely vary period to period, but that over time will produce a predictable rate of return.²⁰

TOLIC clearly ignores the fact that it has always been intended that the segment closing adjustment be a point in time measurement related to the date of the segment closing event. The segment closing provision provides for a current period settling up of assets and liabilities based on current market values and pension plan provisions. The Board's concern that the use of a particular date could "result in an inequitable calculation" recognized that occasionally there

¹⁸ Paragraph CAS 413-50(c)(12) as originally promulgated on June 2, 1976, stated, in part, that "[t]he calculation of the difference between the market value of the assets and the actuarial liability shall be made as of the date of the event (e.g., contract termination) that caused the closing of the segment. If such a date cannot be readily determined, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date."

¹⁹ CAS 413-50(c)(12)(i) reads, in part, that: "[t]he actuarial assumptions employed shall be consistent with the current and prior long term assumptions used in the measurement of pension costs."

²⁰ It should be noted that common actuarial practice is to slightly reduce the long-term expected rate of return to provide a degree of conservatism and protect the interests of the plan participants and the plan sponsor.

could be an anomalous spike or drop in market values coincident with the day of the segment closing event. This provision was never intended to protect the contractor or the Government from changes in the market value of assets in a subsequent period.

TOLIC's analysis is premised upon a complete misunderstanding of Section 5 of Preamble A to the original CAS 413. This section addresses the relationship of actuarial smoothing techniques, i.e., actuarial value of assets, to period-to-period swings in market values. Both CAS Boards permit the use of asset values other than the current market value in furtherance of their shared goal of consistency and predictability between cost accounting periods. However, paragraph CAS 413-50(c)(12) clearly requires the use of the market value, not actuarial value, of the assets as of the date of the segment closing event.

The auditors should reject this specious contention by TOLIC for the same well-founded reasons that they have never considered recommending, in other audit reports, that segment closing adjustments of other contractors be increased simply because the following accounting period happened to yield better-than-average investment returns.

4. The full amount of the premium paid to TOLIC for the purchase of the annuity contract should have been recognized in the measurement of the segment closing adjustment.

TOLIC Comment: TOLIC believes that the premium paid to itself for the annuity contract was reasonable, and therefore allowable. TOLIC contends that the auditors incorrectly looked to the FAR provisions on self-insurance and captive insurers in assessing the reasonability and allowability of the premium paid for the annuity contract. TOLIC further claims that the annuity contract is not insurance as defined and covered by the FAR. Finally, TOLIC believes that because the premium for the annuity contract was paid from pension fund assets and to a qualified insurance company, as determined by Brentwood Advisors, the amount of such payment is determinative as an allowable pension cost.

Response: Most of my response to TOLIC's comments appears in my memorandum to you dated November 16, 2001. A copy of this memo is attached. I am augmenting that memo with some remarks concerning specific comments raised by TOLIC.

Subparagraph CAS 413-50(c)(12)(i) clearly states that the liability used to determine the segment closing adjustment "shall be measured as the amount paid to irrevocably settle all benefit obligations," i.e., the premium paid for a non-participating annuity contract. CAS 413 does not address whether the premium amount paid is reasonable and allowable. That determination is made under the cost principles and insurance provisions of FAR Parts 28 and 31. In my November 16, 2001 memo, I examined FAR 31.205-19, FAR 28.300, and CAS 416-50(a)(1) for guidance. My analysis found that the amount paid for the annuity contract from TOLIC exceeded the amount that is reasonable and allowable, and that the allowable segment closing adjustment should be measured by an annuity bid from Principal Life.

TOLIC's assertion that annuities are not insurance ignores the fact that the company's own advisors considered only licensed insurance companies as possible bidders. FAR Part 2²¹ defines insurance as follows:

Insurance, as used in this part, means a contract which provides that for a stipulated consideration, one party undertakes to indemnify another against loss, damage, or liability arising from an unknown or contingent event.

TOLIC seems to be misled by the adjective "contingent." The insurance provisions of the FAR cover annuity contracts. Pension actuaries, like all other actuaries, are trained in the evaluation of the financial effects of insurance risks, i.e., risks associated with future unknown or contingent events. Pension actuaries are concerned with the financial risk (need for income) of living after retirement. Pension actuaries consider many contingencies (survival, termination of employment, future salaries, and marital status), including the one that TOLIC believes the other bidders misevaluated; namely, early retirement.

TOLIC expresses its opinion, but provides no supporting documentation or evidence, that the other three bidders did not properly value the early retirement features of the TOLIC pension plan, even after two of the bidders submitted revised bids in response to a suggestion by TOLIC personnel that they consider doing so. There is every reason to believe that these three large insurance companies were prepared to honor their bid offers and were financially capable of accepting the full liability for the promised pension benefits.

Please feel free to contact me at 410-786-6381 if you have any questions.

²¹ The definition of the term "insurance" as used in FAR Parts 2.8 and 31 is found in FAR Part 2.